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American Institute of Certified Public Accountants. Task Force on Single Audits of Federal Financial Assistance

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EXPOSURE DRAFT

PROPOSED AUDIT GUIDE

**AUDITS OF FEDERAL FINANCIAL ASSISTANCE TO
STATE AND LOCAL GOVERNMENTAL UNITS**

DECEMBER 28, 1984

Prepared by the Task Force on Single Audits of Federal Financial Assistance
of the American Institute of Certified Public Accountants

Comments should be received by May 1, 1985, and addressed to
Frank S. Synowiec, Jr., Federal Government Division, File E1403
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EXPOSURE DRAFT

PROPOSED AUDIT GUIDE

AUDITS OF FEDERAL FINANCIAL ASSISTANCE TO STATE AND LOCAL GOVERNMENTAL UNITS

DECEMBER 28, 1984

**Prepared by the Task Force on Single Audits of Federal Financial Assistance
of the American Institute of Certified Public Accountants**

December 28, 1984

An exposure draft of a proposed AICPA Audit Guide, Audits of Federal Financial Assistance to State and Local Governmental Units, accompanies this letter. This proposed guide discusses those aspects of auditing that are unique to audits of federal financial assistance and the requirements of the Single Audit Act of 1984 (Pub. L. No. 98-502).

Generally, the Single Audit Act of 1984 requires each state and local government that receives, directly or indirectly, \$100,000 or more of federal financial assistance to have an independent audit conducted annually (unless law or regulation provides for biennially) on an organizationwide basis rather than on a grant-by-grant or program-by-program basis. Those governments that receive between \$25,000 and \$100,000 in federal financial assistance may elect to have a single audit conducted or meet individual program audit requirements. There are no specific audit requirements for those state and local governmental units that receive less than \$25,000 annually.

The Governmental Accounting Standards Board has the authority to set accounting standards for state and local governmental units. The discussion of accounting in this exposure draft is limited to providing guidance on existing standards and practices.

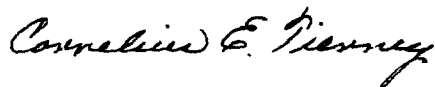
The Single Audit Act requires the auditor to report identified material instances of noncompliance with each major federal assistance program and any instance of noncompliance found in transactions relating to nonmajor federal assistance programs. However, considerable controversy surrounds the definition of materiality as it relates to compliance with applicable laws and regulations. Accordingly, the guide provides that the independent auditor should consider reporting all identified instances of noncompliance and allow the grantor to determine whether further action is needed. Commentators on the proposed guide are specifically requested to comment on such an approach.

The Single Audit Act requires the director of the Office of Management and Budget to prescribe policies, procedures, and guidelines to implement the act. Such policies, procedures, and guidelines have not been issued in time to be incorporated in this proposed guide, but they will be incorporated into the final published guide.


Comments or suggestions on any matter contained in this exposure draft will be appreciated. The consideration of responses will be helped if the comments refer to specific paragraphs, explain the problems, and include supporting reasons for any suggestions or comments.

Responses should be addressed to Frank S. Synowiec, Jr., in time to be received by May 1, 1985. Written comments on the exposure draft will become part of the public record of the AICPA Federal Government Division and will be available for public inspection at the AICPA's offices after June 3, 1985, for one year.

Sincerely,



Cornelius E. Tierney, Chairman
Task Force on Single Audits of
Federal Financial Assistance



Joseph F. Moraglio, Director
Federal Government Division

SUMMARY

This proposed audit guide provides guidance to independent auditors when conducting financial and compliance audits of federal assistance programs awarded to state and local governmental units and Indian tribal governments as required by the Single Audit Act of 1984, Public Law 98-502. This guide and the Industry Audit Guide, Audits of State and Local Governmental Units, are applicable when an auditor is engaged to examine and report on the general purpose financial statements of governmental units that include federal financial assistance funds.

Areas discussed in the proposed guide include the following:

- o Legal and regulatory requirements
- o Findings and questioned costs
- o Requirements applicable to subrecipients of federal financial assistance
- o Initial-year audit and stub periods
- o Responsibilities of cognizant agency
- o Joint audit considerations

In addition, the proposed guide illustrates auditors' reports on financial statements and internal accounting control and auditors' comments on compliance with applicable laws and regulations.

The exposure draft has been sent to—

- o State society presidents, directors, and committee chairmen.
- o Organizations concerned with regulatory, supervisory, or other public disclosures of financial activities.
- o Organizations, firms, and individuals identified as having an interest in federal, state, and local government accounting.
- o Persons who have requested copies.

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The task force wishes to acknowledge the contributions made to the development of this audit guide by Harold I. Steinberg, Martin Sacks, and Jeffrey A. Jones, former members of the task force.

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PREFACE

Numerous grant programs provide billions of dollars annually to the fifty states, some three thousand counties, and nearly eighty thousand local governments, districts, and other organizations. Recipients of those funds assume various responsibilities, one of which may be to arrange for audits by independent auditors. In the past, the scope of independent audits was limited in many instances to individual funding awards or programs; however, Congress has decided that the numerous individual audits could and should be replaced by single, organizationwide audits. Such an approach for federal financial assistance programs was made federal policy on October 22, 1979, by the U.S. Office of Management and Budget's (OMB) Attachment P, "Audit Requirements for State and Local Governments," to Circular A-102, Uniform Administrative Requirements for Grants-In-Aid to State and Local Governments. The single audit concept was enacted into law in October 1984. The Single Audit Act of 1984 (Pub. L. No. 98-502) is intended to improve financial management and establish uniform audit requirements for federal financial assistance provided to state and local governments.

This guide provides guidance to independent auditors when performing audits involving federal, state, or local assistance under the requirements of the Single Audit Act of 1984 or other applicable laws and regulations. This guide and the AICPA Industry Audit Guide, Audits of State and Local Governmental Units, are applicable when an auditor is engaged to examine and report on the general purpose financial statements of governmental units that include federal, state, and local grant funds.

The type of report that an auditor can issue depends on the financial statements that a governmental unit presents and on the scope of the examination. The general purpose financial statements referenced in the National Council on Governmental Accounting's (NCGA) Statement 1, as listed in paragraph 4 of the AICPA's Statement of Position (SOP) 80-2, Accounting and Financial Reporting by Governmental Units, and adopted by the Governmental Accounting Standards Board (GASB) in its Statement No. 1, Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide, are required for conformity with generally accepted accounting principles.* A governmental unit may issue additional financial statements or supporting schedules for inclusion in a comprehensive financial report or to comply with federal, state, and local requirements. The auditor's report on such presentations is also described in SOP 80-2 and in this guide.

Finally, this guide also describes the form of the auditors' report when they are engaged to examine and report on financial statements or schedules of

*In October 1984, the AICPA issued an exposure draft of a proposed revision of the Audit and Accounting Guide, Audits of State and Local Governmental Units. When it is published in final form, SOP 80-2 will be superseded. In addition, the illustrative reports included in this guide generally are consistent with the illustrative reports included in the proposed Audit and Accounting Guide, Audits of State and Local Governmental Units.

federal, state, and local assistance, such as a supplementary schedule of federal assistance.

This guide does not provide guidance for economy and efficiency or program results audits.

CHAPTER 1

INTRODUCTION

BACKGROUND AND HISTORY

1.1 To monitor the flow of billions of dollars spent annually for federal financial assistance and state and local grant programs, the federal government and state and local governments rely on audits by independent auditors.

1.2 Traditionally, the scope of a federally required audit has been limited to an examination of the financial statements for a single federal award program, grant, award, or other federal assistance, and a test of the recipient's compliance with the terms of the individual federal assistance agreement. Each federal agency required its own audit guidelines to be followed and a specific report issued for its own programs; no agency was responsible for all federal financial assistance awarded to a single recipient organization. In many instances, the same internal accounting control systems and transactions were subjected to numerous reviews and tests, and frequently the recipient organization was audited by different groups simultaneously.

1.3 In a report issued in 1979, the General Accounting Office (GAO) noted that the individual audits of recipients of federal financial assistance were inadequate and did not optimize the use of audit resources.¹ The report concluded that the ideal way to audit federal assistance programs is to require a single financial and compliance audit of a recipient rather than individual audits of each program. The GAO believed that the federal auditing process had to be improved and made several recommendations to Congress, to the director of the OMB, and to the heads of federal departments and agencies that administer grants and programs. Among the recommendations were that the director of the OMB—

- o Designate a cognizant federal agency to represent the federal government for single audits.
- o Direct cognizant agencies to use a standard audit guide or a suitable replacement in auditing multifunded recipients.
- o Develop a nationwide system to identify federal funding that recipients may receive and stipulate that all audits must comply with federal audit guidelines.

¹The U.S. General Accounting Office report to Congress, Grant Auditing: A Maze of Inconsistency, Gaps, and Duplication That Needs Overhauling, June 15, 1979.

1.4 In addition, in 1979 the Joint Financial Management Improvement Program (JFMIP) issued a report on its study of federally assisted programs,² which concluded that the piecemeal practice of auditing federal assistance programs resulted in the duplication and overlap of audit efforts and gaps in audit coverage and led to audit coordination problems. The JFMIP believed that federal agencies should adopt the single audit approach to auditing federal assistance programs.³

OMB CIRCULAR A-102, ATTACHMENT P

1.5 In response to the aforementioned recommendations, on October 22, 1979, the OMB revised its policy directive, Circular A-102, Uniform Administrative Requirements for Grants-in-Aid to State and Local Governments, adding a new Attachment P, entitled "Audit Requirements For State and Local Governments" (hereafter referred to as Attachment P).⁴ Attachment P established audit policies applicable to federal assistance programs to state and local governments and to Indian tribal governments that receive federal financial assistance. Nonfederal funds were not subject to the provisions of Attachment P, and Attachment P did not apply to state and local institutions of higher education or hospitals, which are covered by OMB Circular A-110, Uniform Administrative Requirements for Grants and Other Agreements with Universities, Hospitals and Other Nonprofit Organizations.

THE SINGLE AUDIT ACT OF 1984

1.6 After extensive deliberations, Congress, on October 4, 1984, passed the Single Audit Act of 1984 (hereafter referred to as the Single Audit Act).⁵

The objectives of that act are—

- o To improve the financial management of state and local governments with respect to federal financial assistance programs.

² Audit Improvement Project, The Joint Financial Management Improvement Program Audit Improvement Project, Report on Audit of Federally Assisted Programs: A New Emphasis (Washington, D.C.: U.S. Government Printing Office, February 1979).

³ The auditor's qualifications for performing government audits are contained in the General Accounting Office publication entitled Standards for Audit of Governmental Organizations, Programs, Activities and Functions (Washington, D.C.: U.S. Government Printing Office, 1981) (hereafter referred to as the GAO's Standards for Audit).

⁴ The OMB is drafting a new circular pursuant to the Single Audit Act of 1984, Pub. L. No. 98-502, that will establish audit requirements for state and local governments that receive federal financial assistance, and defines federal responsibilities for implementing and monitoring those requirements. The new circular will supersede Attachment P dated October 22, 1979.

⁵ The Single Audit Act is Appendix E of this guide.

- o To establish uniform requirements for audits of federal financial assistance provided to state and local governments.
- o To promote the efficient and effective use of audit resources.
- o To ensure that federal departments and agencies, to the maximum extent practicable, rely upon and use audit work done pursuant to the requirements of the Single Audit Act.

1.7 The terms single audit, organizationwide audit, and entitywide audit are frequently used synonymously. Such terms generally refer to an audit of the financial statements and a test of compliance with statutory and regulatory requirements of an organization receiving federal financial assistance from any source, and in general, such terms are consistent with the Single Audit Act. NCGA Statement 3, Defining the Governmental Reporting Entity, defines the characteristics of the reporting entity for which financial statements should normally be prepared under generally accepted accounting principles.

1.8 The single audit represents a significant revision in the federal government's audit policy because generally it requires the reporting entity to have its federal assistance programs audited on an organizationwide basis rather than on a grant-by-grant basis. Under the single audit concept, all federal assistance programs administered by the organization are included in the scope of the audit.

AUDIT REQUIREMENTS

1.9 Under the audit requirements of the Single Audit Act, each state and local government that receives a total amount of federal financial assistance—

- o Equal to or in excess of \$100,000 in any fiscal year of such government shall have a single audit made for such fiscal year.⁶
- o Equal to or in excess of \$25,000, but less than \$100,000 in any fiscal year of such government has the option of having a single audit made or complying with any applicable requirements concerning financial or financial and compliance audits contained in federal statutes and

⁶If a state or local government's constitution, statute, administrative rules, regulations, guidelines, standards, or policies require audits less frequently than annually, the Single Audit Act provides that the cognizant agency shall, upon request of such government, permit the government to conduct biennial audits, which cover both years. After December 31, 1986, such audits must be made annually unless the recipient government codifies a requirement for biennial audits.

regulations governing programs under which such federal financial assistance is provided to that government.⁷

- o Of less than \$25,000 in any fiscal year is exempt from complying with the audit requirements of the act. However, such state and local government is not exempt from maintaining records concerning federal financial assistance.

1.10 The Single Audit Act requires that single audits conducted "for any fiscal year shall cover the entire state or local government's operations except that, at the option of such government, such audit may . . . cover only each department, agency, or establishment which received, expended, or otherwise administered Federal financial assistance during such fiscal year."⁸ However, each state or local government that, in any fiscal year of such government, receives directly from the Treasury Department a total of \$25,000 or more in general revenue-sharing assistance and that is required to have a single audit conducted, does not have the option of having a single audit conducted of only a department or agency.⁹ The Single Audit Act also provides that a series of audits of individual departments, agencies, and establishments for the same fiscal year may be considered a single audit. The audit may exclude public hospitals and public colleges and universities.

1.11 The reports required by the Single Audit Act include the auditor's report on the financial statements and internal control plus the auditor's comments on compliance.

1.12 State and local governments and Indian tribal governments are required to arrange for audits that will comply with the requirements of the Single Audit Act.

1.13 Exhibit 1-1 is an overview of the single audit process, and it addresses some of the important areas that auditors may wish to consider in conducting such financial and compliance audits. Elements of the audit process that are unique to single audit engagements are clearly indicated and are discussed in more detail in the following chapters. Chapter 6 discusses audits of federal financial assistance programs conducted on other than an organizationwide basis.

⁷If the recipient government elects not to conduct a single audit, the auditor should review applicable federal statutes and regulations governing the awarded federal assistance to ascertain the audit standards, guidelines, and appropriate form of reporting to be used. The auditor should also discuss and agree upon the scope of the engagement with the client and cognizant agency, if deemed necessary.

⁸Section 7502 of the Single Audit Act.

⁹A series of audits carried out over a period of not more than three years covering the total amount in the financial accounts of a state government or unit of general local government is deemed to be a single audit under subsections (a)(1) and (b) of the Revenue Sharing Act.

REQUIREMENTS OF OTHER GOVERNMENTAL UNITS

1.14 In addition to the Single Audit Act and GAO and OMB audit requirements, many state and local governmental units have both financial and compliance requirements that need to be considered in conducting single audits. This guide discusses the general nature of audit tests and inquiries that might be required to satisfy audit requirements of those other levels of governments; the specific requirements, however, are not provided. Therefore, the auditor is well advised to identify both federal and other governmental units' financial and compliance requirements in conducting a single audit.

1.15 In planning a single audit, the auditor should be aware that although a significant amount of a state or local government's budget may be funded by the federal government, the budget is also funded from other sources as well. For instance, state governments receive funding from nonfederal grantors, and local governments receive funding from state and other levels of government. The reporting entity's management is responsible for informing and advising the auditor of those applicable legal and regulatory requirements. To test the financial transactions and compliance activities affecting those funds, the auditor should be familiar with the legal and regulatory requirements related to those funding sources. Many state and local governments have prepared, or will be preparing, audit guides, compliance supplements and other literature that the auditor should be familiar with and should use in connection with the audit, if they are necessary for the conduct of the engagement.

ACCOUNTING AND AUDITING GUIDELINES

1.16 The Single Audit Act requires that, in addition to following generally accepted auditing standards, the auditor should follow the general standards and the additional standards set forth in the financial and compliance element of the GAO's 1981 Standards for Audit of Governmental Organizations, Programs, Activities, and Functions (hereafter referred to as the GAO's Standards for Audit).

1.17 The GAO's Standards for Audit includes three elements of expanded scope auditing:

1. Financial and compliance - determines (a) whether the financial statements of an audited entity present fairly the financial position and the results of financial operations in accordance with generally accepted accounting principles and (b) whether the entity has complied with laws and regulations that may have a material effect upon the financial statements.
2. Economy and efficiency - determines (a) whether the entity is managing and utilizing its resources (such as personnel, property, space) economically and efficiently, (b) the causes of inefficiencies or uneconomical practices, and (c) whether the entity has complied with laws and regulations concerning matters of economy and efficiency.
3. Program results - determines (a) whether the desired results or benefits established by the legislature or other authorizing body are being

achieved and (b) whether the agency has considered alternatives that might yield desired results at a lower cost.¹⁰

1.18 The GAO's Standards for Audit does not require that all three elements be performed on every audit, and generally all three elements are not present in the same engagement. The economy and efficiency element and the program results element of audits are not required by the Single Audit Act.

1.19 The AICPA Industry Audit Guide, Audits of State and Local Governmental Units,¹¹ including amendments, provides guidance to CPAs in their examination of the financial statements of state and local governmental units. Additional guidance for conducting financial and compliance audits under the requirements of the Single Audit Act and other applicable regulations or legislation is provided in the following chapters of this guide.

1.20 In March 1979 the NCGA published Statement 1, Governmental Accounting and Financial Reporting Principles, containing the principles of accounting and reporting applicable to state and local governmental organizations. The AICPA's SOP 80-2, Accounting and Financial Reporting by Governmental Units, states that financial statements presented in accordance with NCGA Statement 1 are in conformity with generally accepted accounting principles.¹²

1.21 Section 7502 of the Single Audit Act requires the auditor to express an opinion as to whether the financial statements are fairly presented in conformity with generally accepted accounting principles. However, because of legal, regulatory, or other requirements, some state and local governmental units prepare their financial statements in conformity with a comprehensive basis of accounting other than generally accepted accounting principles. The Single Audit Act does not prohibit such practice; nonetheless, if financial statements are not prepared in conformity with generally accepted accounting principles, auditors should state in their report the nature of variances therefrom. Auditors' reports prepared in accordance with generally accepted auditing standards will meet this requirement. Specifically, if financial statements are presented on a comprehensive basis of accounting other than generally accepted accounting principles, they are reported on in accordance with Statement on Auditing Standard (SAS) No. 14, Special Reports, which requires the report to (a) state, or refer to a note in the financial statements that states, the basis of presentation, (b) refer to a note that describes how the basis differs from generally accepted accounting principles, and (c) state that the financial statements are not intended to be presented in conformity with generally accepted accounting principles.

¹⁰GAO's Standards For Audit, 12.

¹¹In October 1984, the AICPA issued an exposure draft of a proposed revision of the Audit and Accounting Guide, Audits of State and Local Governmental Units.

¹²The independent auditor should refer to pronouncements of the GASB and the statements and interpretations of the NCGA, which are recognized in GASB Statement No. 1. The GASB had several accounting and financial reporting issues under study at the time this draft audit guide was published; hence, the auditor should be alert to current GASB pronouncements.

1.22 If the financial statements are intended to be presented in conformity with generally accepted accounting principles but contain a material departure, SAS No. 2, Reports on Audited Financial Statements, requires the auditor's report to express a qualified or adverse opinion and to explain the reasons for the qualification and the effects of the departure, if reasonably determinable. In addition to the basis of accounting on which the financial statements are presented, the auditor needs to consider whether all the financial statements are included that NCGA Statement 1 requires, and whether to qualify the report if required statements are omitted. See chapter 4, "Financial Statements," of this guide for further discussion.

SUMMARY OF APPLICABLE LITERATURE

1.23 In preparation for a single audit, independent auditors should familiarize themselves with the following pertinent documents, many of which are mentioned in this guide.

The Single Audit Act of 1984, Pub. L. No. 98-502 (included as Appendix E to this guide).

98th Congress Senate Committee on Governmental Affairs Report No. 98-234 - Uniform Single Audit Act of 1983 [to accompany S.1510] September 22, 1983.

This document may be obtained from the Senate Document Room, Room B-4, Hart Senate Office Building, Washington, DC 20510.

98th Congress House of Representatives Committee on Government Operations Report No. 98-708 Single Audit Act of 1984 [to accompany H.R. 4821] April 25, 1984.

This document may be obtained from the House Document Clerk, U.S. Capitol, Room H-226, Washington, DC 20515.

American Institute of Certified Public Accountants

- o Statements on Auditing Standards and related auditing interpretations
- o Industry Audit Guide, Audits of State and Local Governmental Units (including SOP amendments)
- o AICPA Ethics Interpretation 501-3, "Failure to follow Standards and/or Procedures or other Requirements in Governmental Audits"

AICPA documents may be obtained from the order department of the American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036.

General Accounting Office

- o Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, 1981 revision

The Standards for Audit may be obtained from the Superintendent of Documents, Public Documents Department, U.S. Government Printing Office, Washington, DC 20402.

Governmental Accounting Standards Board

- o Statement No. 1, Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide

GASB documents may be obtained from the Governmental Accounting Standards Board, High Ridge Park, P.O. Box 3821, Stamford, CT 06905.

Joint Financial Management Improvement Program

- o Cognizant Audit Agency Guidelines

This document may be obtained from the Joint Financial Management Improvement Program, Suite 705, 666 Eleventh Street, N W, Washington, DC 20001.

Office of Management and Budget

- o Circular A-102, Uniform Administrative Requirements for Grants-in-Aid to State and Local Governments
- o Compliance Supplement for Single Audits of State and Local Governments (often referred to as the Compliance Supplement)
- o Circular A-87 Cost Principles Applicable to Grants and Contracts With State and Local Governments

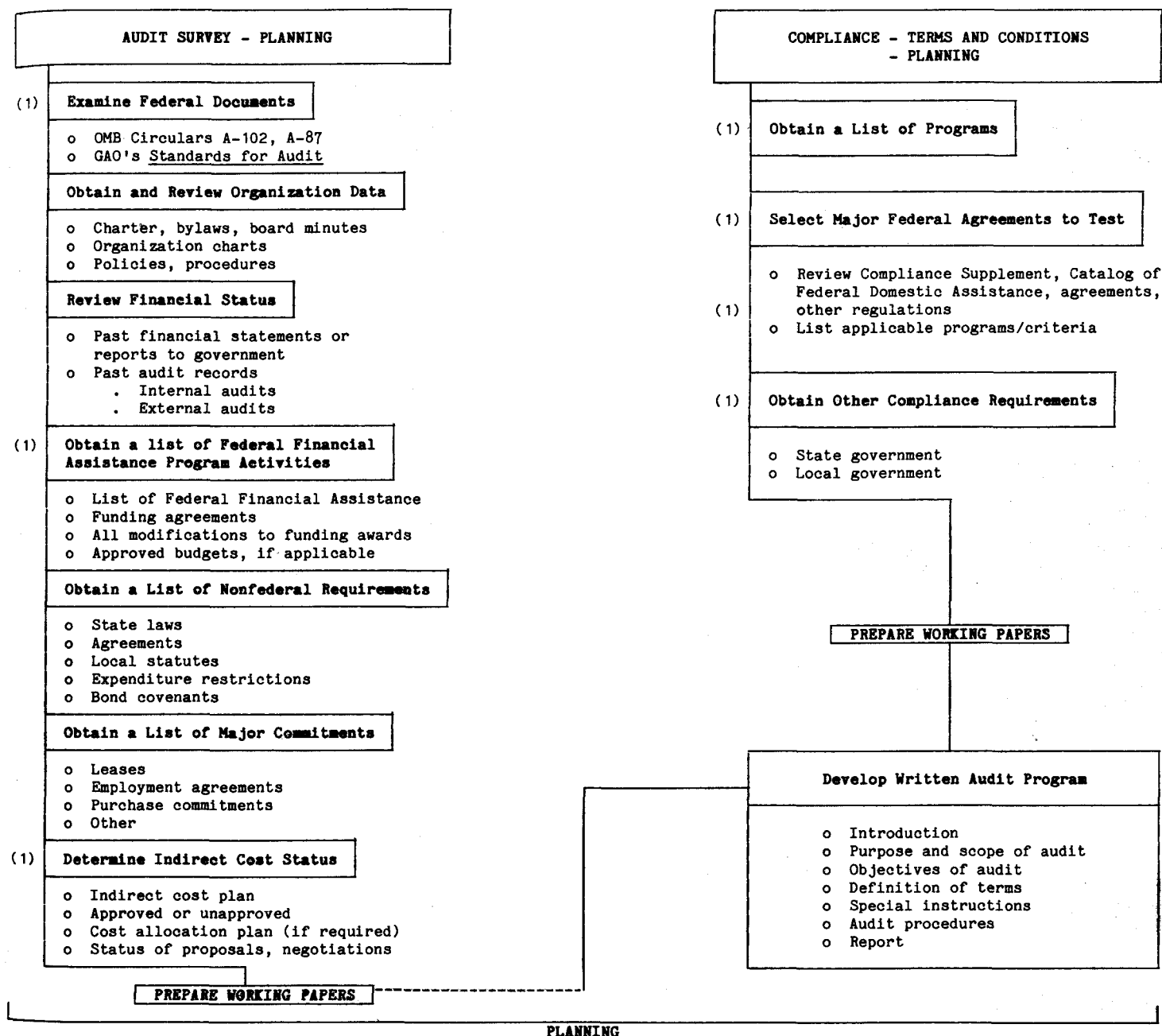
OMB documents may be obtained from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

- o NCGA Statements—seven were issued prior to NCGA discontinuing its activities in 1984.
- o NCGA Interpretations—eleven were issued through 1984.

These documents may be obtained from the Government Finance Officers Association, 180 North Michigan Avenue, Suite 800, Chicago, IL 60601.

1.24 Since OMB circulars are an important medium of policy dissemination within the federal government, Appendix B of this guide summarizes OMB Circulars A-87 and A-102, which are applicable to single audits of federal financial assistance programs.

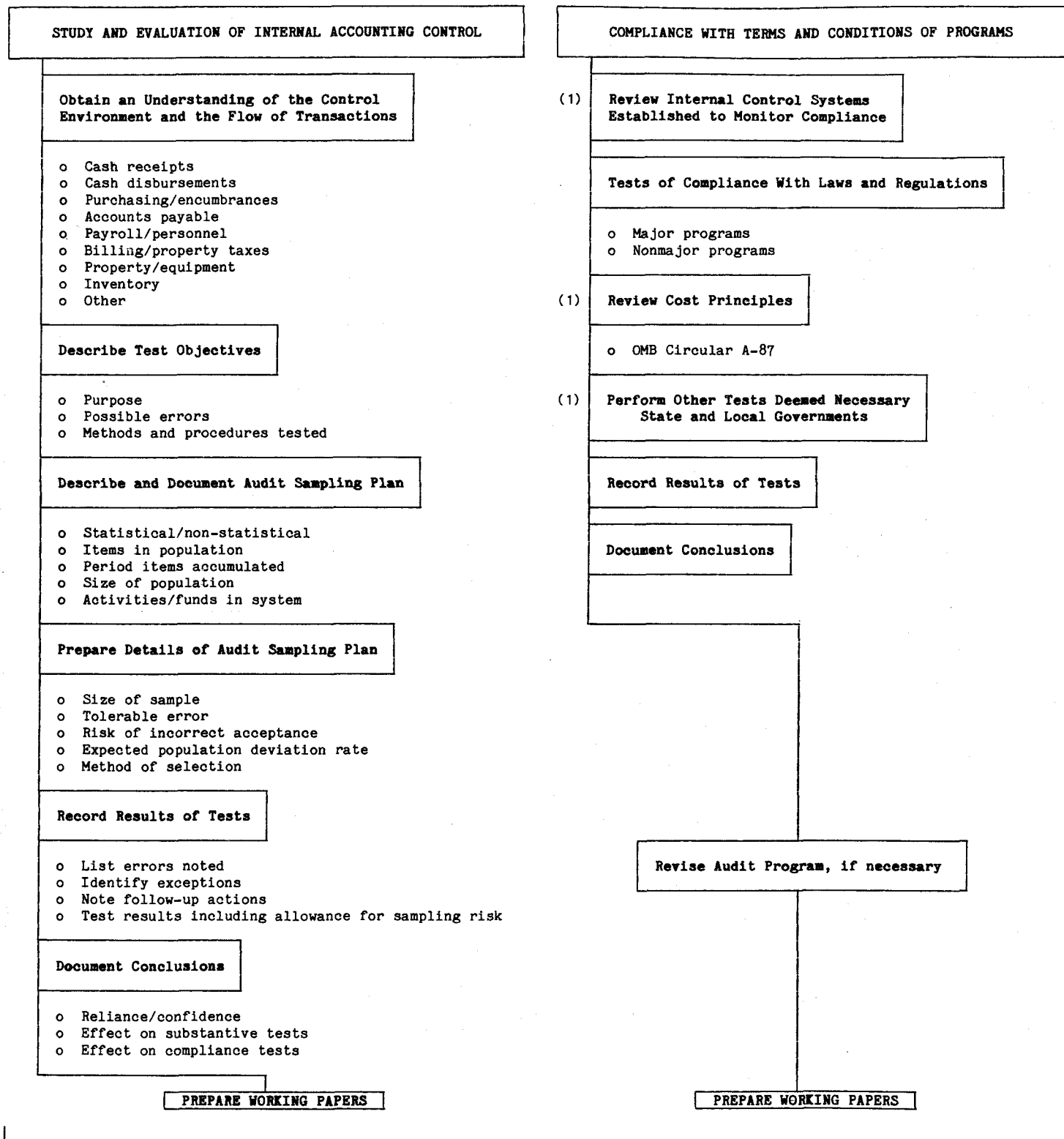
OVERVIEW OF GUIDELINES FOR FINANCIAL AND COMPLIANCE AUDITS OF STATE AND LOCAL GOVERNMENTAL UNITS



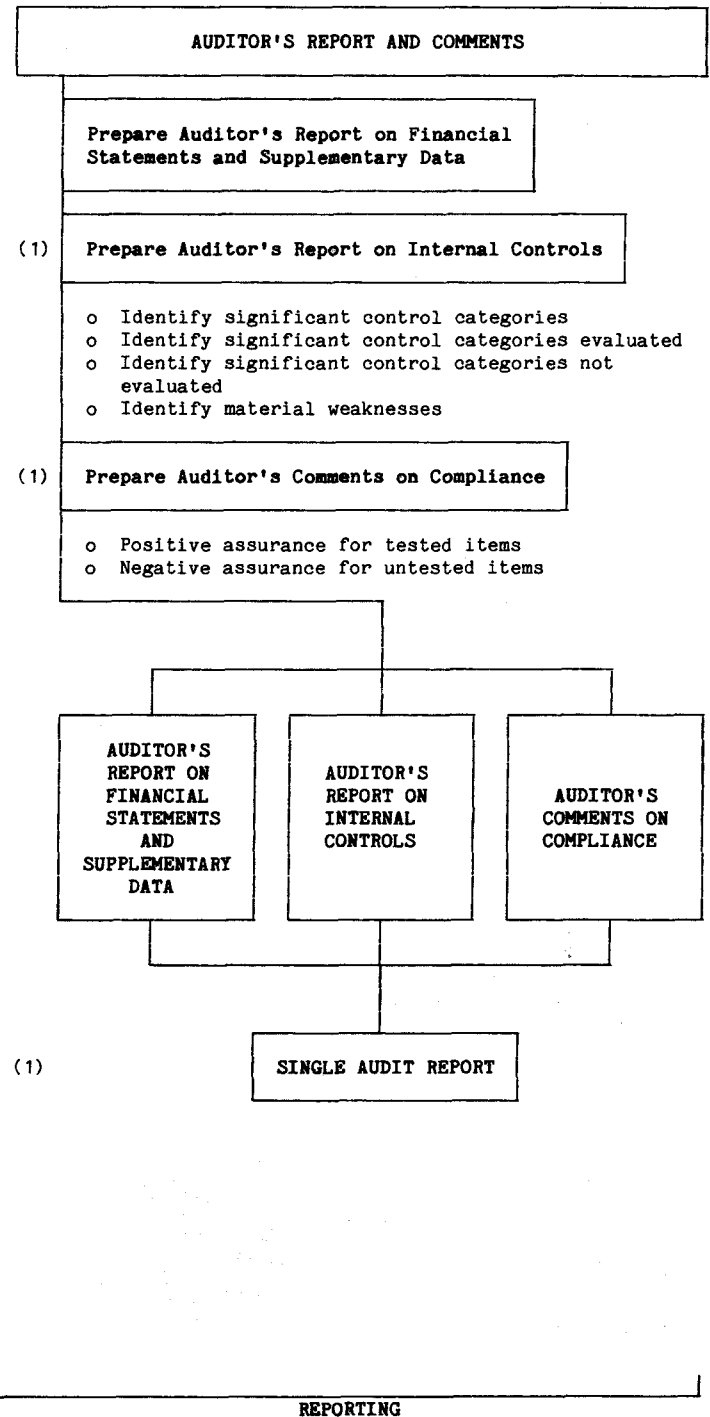
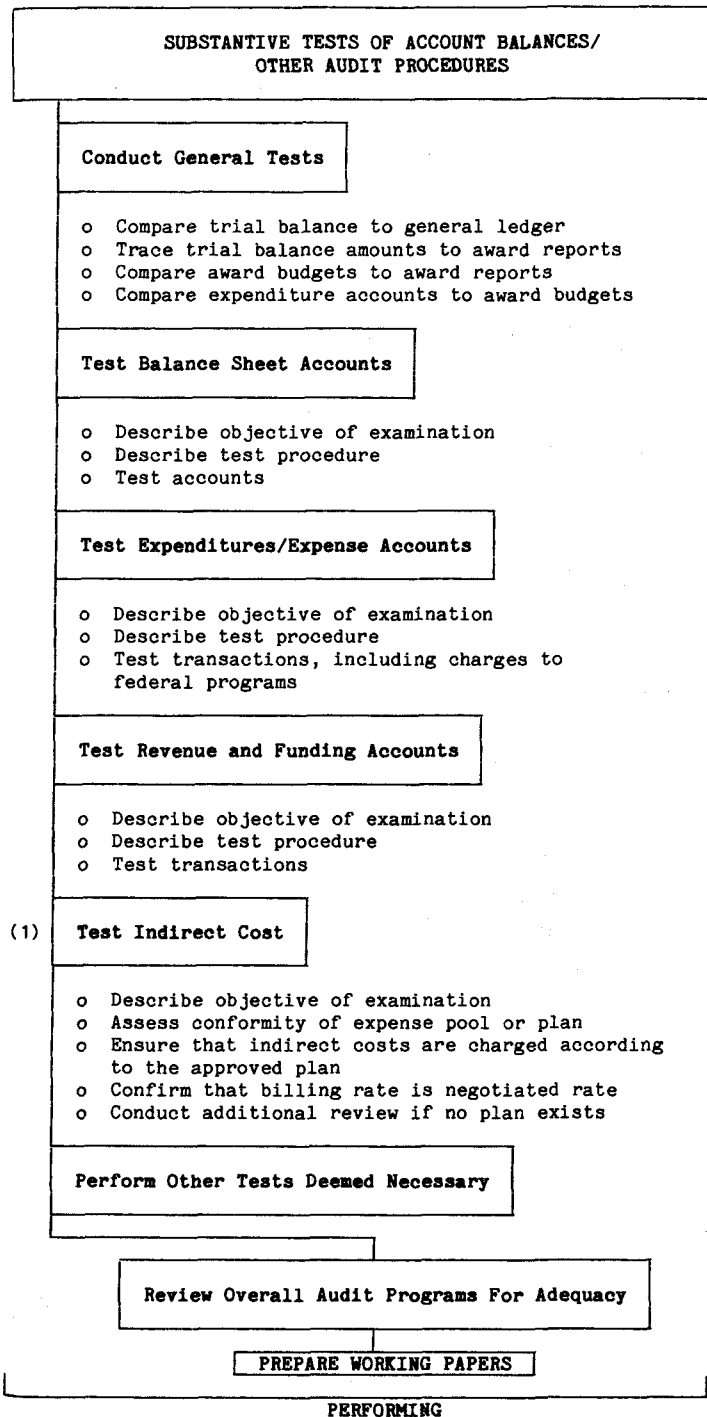
Note: This illustrative overview highlights, in summary form, the various requirements of OMB Circular A-102, and the GAO's Standards for Audit. This overview also provides guidance to the auditor to use in planning and conducting a financial and compliance audit of state and local governmental units. It is not an audit program and does not include all detailed procedures and steps necessary to express an opinion on the financial statements. Depending on the circumstances, this illustrative overview should be revised to fit the requirements of each engagement.

Certain procedures indicated on this overview relate to an examination in accordance with the GAO's Standards for Audit and are not necessarily required in an examination in accordance with generally accepted auditing standards. Obtaining evidential matter in an examination in accordance with generally accepted auditing standards involves performing auditing procedures that satisfy audit objectives developed in light of assertions embodied in the financial statements. SAS No. 31, Evidential Matter, enumerates the broad categories of assertions embodied in the financial statements.

(1) The extent of planning and performing tests may be unique to single audits.



PERFORMING



CHAPTER 2

AUDIT PLANNING AND OTHER CONSIDERATIONS

2.1 This chapter introduces and discusses certain auditing and reporting requirements that the auditor should consider in planning a single audit.

2.2 The auditor should be aware that the Single Audit Act and the GAO's Standards for Audit establish specific requirements that extend beyond generally accepted auditing standards and have special significance to federal and state program managers and other users of the audited financial statements. Some of these requirements relate to the following:

- o Specific reporting requirements (including schedule of federal assistance, report on internal control, and comments on compliance)
- o Legal and regulatory requirements
- o Findings and questioned costs
- o Working papers
- o Disclosure of irregularities and illegal acts
- o Identifying federal financial assistance programs
- o Subgrantees (or subrecipients) of federal financial assistance programs

2.3 Other important matters that the auditor should consider in planning an audit of governmental programs include, but are not limited to, the following:

- o State and local government audit considerations
- o Block grant programs
- o Definition of the reporting entity
- o Determination of the audit period
- o Initial year audit and stub periods
- o Relationship with the cognizant agency
- o Responsibilities of the cognizant agency
- o Joint audit considerations
- o Formalizing the engagement arrangement

SPECIFIC REPORTING REQUIREMENTS

2.4 The Single Audit Act and the GAO's Standards for Audit extend the auditor's reporting responsibilities beyond the expression of an opinion on the financial statements. The Single Audit Act requires that each audit encompass the entire financial operations of the government, department, agency, or establishment, whichever is applicable, and shall determine and report whether—

- o The financial statements of such reporting entity present fairly its financial position and results of its financial operations in conformity with generally accepted accounting principles, and such reporting entity has complied with laws and regulations that may have a material effect upon the financial statements.¹
- o The government, department, agency, or establishment has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations.
- o The government, department, agency, or establishment has complied with laws and regulations that may have a material effect upon each major federal assistance program.

2.5 The Single Audit Act requires the auditor to determine and report whether the government, department, agency, or establishment has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations.

2.6 The auditor is not required to render an opinion on the recipient's internal control systems over its federal financial assistance programs. However, the auditor's report on the study and evaluation of the systems should identify, at a minimum, the controls in place and studied, the material weaknesses found, and the controls not relied on and the reasons therefor. The report should provide sufficient information to permit federal, state, and local officials to judge whether the controls in place provide reasonable assurance that the recipient is managing federal assistance programs in compliance with applicable laws and regulations.

¹The exposure draft of a proposed AICPA Audit and Accounting Guide, Audits of State and Local Governmental Units, specifies that the auditor's opinion on the general purpose combined financial statements is an opinion on each of the fund types and account groups, and the example reports provided in that draft make that clear. The implication is that audit scope and materiality evaluations should be determined on that basis. The original audit guide and SOP 80-2 discussed the auditor's opinions and provided examples that referred to the financial position and results of operations of the governmental unit "taken as a whole." The AICPA State and Local Government Accounting Committee believes the exposure draft is merely eliminating confusion over original intent. The reader may wish to refer to the exposure draft of the proposed AICPA Audit and Accounting Guide, Audits of State and Local Governmental Units, for additional information and discussion.

2.7 The Single Audit Act defines internal controls as "the plan of organization and methods and procedures adopted by management to insure that—

- (A) resource use is consistent with laws, regulations and policies;
- (B) resources are safeguarded against waste, loss, and misuse; and
- (C) reliable data are obtained, maintained, and fairly disclosed in reports."²

2.8 The GAO's Standards for Audit also requires a report containing written comments beyond those required by SAS No. 30, Reporting on Internal Accounting Control, relating to the auditor's study and evaluation of the system of internal accounting control made as a part of the audit. It also requires written comments on the entity's compliance with applicable laws and regulations, expressing positive assurance for the items tested and negative assurance for the items not tested.

LEGAL AND REGULATORY REQUIREMENTS

2.9 In governmental auditing at all levels, compliance with applicable laws and regulations is particularly important because governmental organizations, functions, programs, and activities are created by laws and have more specific rules and regulations than are usually applicable to private organizations. Failure to comply with such laws and regulations could have an adverse effect on the financial statements.

2.10 Thus, the AICPA Industry Audit Guide, Audits of State and Local Governmental Units, in its discussion of compliance with legal requirements, states that "it is necessary for the auditor to gain a working knowledge of applicable laws and to apply that knowledge in his auditing and reporting."³ SAS No. 17, Illegal Acts by Clients, states that as part of his examination, the auditor considers compliance with laws and regulations that have a direct effect on amounts presented in the financial statements. Similarly, NCGA Statement I also requires disclosures of legal violations that could have a material effect on the financial statements. The Single Audit Act requires that each government, department, agency, or establishment comply with laws and regulations that may have a material effect on the financial statements and on each major federal assistance program.

2.11 Auditors should satisfy themselves that the client has not violated applicable laws and regulations that could materially affect the entity's financial statements or the major federal assistance programs tested. The auditor should test the transactions and operations of the audited organization, its programs, and activities for possible noncompliance with laws and regulations.

²Section 7501 of the Single Audit Act.

³AICPA, Industry Audit Guide, Audits of State and Local Governments, 2d ed. (New York: AICPA, 1978), 37.

Amounts not considered material in relation to the financial statements taken as a whole⁴ could be considered material to a major federal assistance program. All instances of noncompliance detected that have a material effect on the financial statements or on the major federal assistance programs should be reported. In determining noncompliance, the independent auditor is to use his professional judgment in determining what laws and regulations may have a material effect upon each program. As discussed in chapter 3 of this guide, the auditor may wish to report all identified instances of noncompliance.

2.12 The term compliance is used frequently when referring to a single audit and governmental reporting standards, and it has a different meaning than the term compliance as used in SAS No. 1, section 320, "The Auditor's Study and Evaluation of Internal Control." As described in SAS No. 1, section 320, the purpose of compliance tests is intended to provide a reasonable basis for the auditor to conclude whether internal accounting control procedures are being applied as prescribed.

2.13 On the other hand, for federal programs the purpose of tests of compliance with the major provisions of applicable laws and regulations for grant recipients is (a) to provide a reasonable basis for the auditor to conclude whether financial position and results of operations and major federal assistance programs are materially affected by noncompliance and (b) to provide a reasonable basis for the auditor's specific comments on compliance or noncompliance with laws and regulations.

FINDINGS AND QUESTIONED COSTS

2.14 The GAO's Standards for Audit refers to audit findings and questioned costs. Generally, a finding may be defined as a reportable event, such as a significant matter requiring improvement. The GAO, in its Standards for Audit, describes a finding as the "result of information development; a logical pulling together of information . . . about an organization, program, activity, function, condition, or other matter which was analyzed or evaluated and considered to be of interest, concern, or use to the entity,"⁵ and states that factual data of all findings should be presented accurately and fairly in the auditor's comments on compliance and should include only information, findings, and conclusions that are adequately supported by sufficient evidence in the working papers.

2.15 The Single Audit Act requires the auditor to report whether the government, department, agency, or establishment, whichever is applicable, has complied with laws and regulations that may have a material effect on the financial statements and on each major federal assistance program. Thus, through discussions with management and the cognizant agency, the auditor should gain an understanding of the type of matters that would be considered to be of interest, concern, or use to both the entity and the cognizant agency. For example, the auditor may conclude that filing quarterly financial status reports

⁴See note 1.

⁵GAO's Standards for Audit, 66.

late consistently would be considered a finding, but such a finding would not have a material effect on the entity's financial statements or federal assistance programs and, therefore, would not have to be disclosed in the financial statements in order for those statements to be presented in conformity with generally accepted accounting principles. However, if the auditor, management, or the cognizant agency considers the same finding to be a significant matter and a reportable event, then the auditor should report that finding either in the schedule of findings and questioned costs, the management letter, or both.

2.16 Although the term questioned costs is not defined, such costs are generally those that, in the opinion of the auditor, may not comply with or may not be consistent with the requirements set forth in contracts, awards, statutes, or regulations governing the allocability, allowability, or reasonableness of costs charged to specific awards, programs, or activities. The auditor should consider the effects of questioned costs on all aspects of the engagement.

2.17 With regard to questioned costs, material instances of noncompliance and all instances or indications of fraud, abuse, or illegal acts found during or in connection with the audit are generally reported in the auditor's comments on compliance.⁶ As discussed in chapter 3 of this guide, the auditor may wish to report all identified instances of noncompliance. The report generally includes an identification of the total amounts questioned, if any, as a result of noncompliance, fraud, abuse, or illegal acts for each federal assistance program, without regard to whether a condition giving rise to the questioned cost has been corrected or whether the recipient entity does or does not agree with the finding or questioned cost. If the effect of noncompliance on the financial statements is material, and the auditor concludes that the federal agency will probably disallow the questioned costs, then the auditor should recommend adjusting the financial statements or the federal financial reports or both. Questioned costs are contingencies and are not accrued in the financial statements unless the criteria specified in FASB Statement No. 5, Accounting for Contingencies, are met.

2.18 The auditor should be aware that although instances of noncompliance should be reported as a finding, some instances of noncompliance may not have questioned costs. An example of an audit finding that is not a questioned cost is presented in exhibit 5-7. Discussion of criteria for questioning costs is contained in chapter 3.

WORKING PAPERS

2.19 The GAO's Standards for Audit contains specific requirements for working papers when performing an audit of federal assistance programs. The auditor's working papers should contain the following information:

⁶With regard to reporting illegal acts, the auditor should be aware that such reporting applicable to federal assistance may impose a greater degree of responsibility than does SAS No. 17, Illegal Acts by Clients. SAS No. 17 states that auditors are under no obligation to notify parties other than those within the client's organization.

- o An audit program that includes the purpose and nature of the test (refer to SAS No. 22, Planning and Supervision)
- o Description of audit sampling plans
- o Documentation and evidence concerning the evaluation of internal controls (refer to SAS No. 41, Working Papers, and SAS No. 43, Omnibus Statement on Auditing Standards)
- o Audit conclusions for various sections of the audit

2.20 SAS No. 41 states that the auditor should prepare and maintain working papers, the form and content of which should be designed to meet the circumstances of a particular engagement. As discussed in the auditing interpretation of SAS No. 22, "Planning Considerations for an Audit of a Federally Assisted Program," (AU sec. 9311.04-34) working papers that consist solely of work programs (a checklist on which the auditor has indicated the steps performed) or working papers that are not clear and understandable without supplementary oral explanation will not be viewed as meeting the requirements of the GAO's Standards for Audit.

2.21 For the study, evaluation, and documentation of the system of internal accounting control, and the documentation of substantive tests performed, the working papers should—

- o Document that the system of internal accounting control has been studied and evaluated to the degree necessary to determine whether, and to what extent, other auditing procedures are to be restricted, thus indicating observance of the second standard of fieldwork.
- o Document that the system(s) of internal control has been studied and evaluated to the degree necessary to determine that the established system(s) provides reasonable assurance that the government, department, agency, or establishment is managing federal financial programs in compliance with applicable laws and regulations.
- o Identify the nature, source, and amount of the accounting entries or financial items tested and any related evidential matter examined.
- o Describe in sufficient detail transactions, controls, and systems tested to permit independent identification of the audit work performed.
- o Describe the nature of testing procedures performed.
- o Provide detailed information about exceptions found and their dispositions.
- o Indicate that the work of any assistants has been reviewed.

2.22 The OMB's draft circular implementing the requirements of the Single Audit Act requires auditors to retain workpapers and reports for a minimum of three years from the date of the audit report, unless the auditor is notified

in writing by the cognizant agency to extend the retention period. Audit workpapers are required to be made available upon request to the cognizant agency or its designee or the GAO, at the completion of the audit.

DISCLOSURE OF IRREGULARITIES AND ILLEGAL ACTS

2.23 SAS No. 16, The Independent Auditor's Responsibility for the Detection of Errors or Irregularities, and SAS No. 17, Illegal Acts by Clients, discuss the auditor's responsibilities with respect to irregularities and illegal acts. Additionally, the GAO's Standards for Audit states the following:

The auditors shall extend audit steps and procedures if the examination indicates that fraud, abuse, or illegal acts may have occurred. The extended audit steps should be directed to obtaining sufficient evidence to determine whether in fact they have occurred and, if so, the possible effect on the entity's financial statements.⁷

2.24 When the auditor's examination indicates the presence of errors or possible irregularities and the auditor remains uncertain about whether these may materially affect the financial statements, he should qualify his opinion or issue a disclaimer.

2.25 Paragraph 14 of SAS No. 16 states that the auditor should discuss possible errors or irregularities with an appropriate level of management that is at least one level above the level of those involved. Neither SAS No. 16 nor SAS No. 17 requires the auditor to notify parties other than personnel within the client's organization, and SAS No. 17 states that generally the decision to notify other parties is the responsibility of management.

2.26 The auditor should be aware that the GAO's Standards for Audit requires that all fraud, abuse, or illegal acts, whether material or not, that come to the attention of the auditor should normally be covered in a separate written report. Usually, management is aware of this reporting requirement. The auditor should consider documenting in the working papers discussions with the cognizant agency concerning the timely notification of irregularities or illegal acts.

2.27 Both SAS No. 16 and SAS No. 17 discuss situations in which the auditor may wish to consult with legal counsel about withdrawing from the engagement. However, it would not be appropriate for the auditor to withdraw from the engagement without first reporting the irregularity or illegal act to management and the appropriate governmental agencies.

IDENTIFYING FEDERAL FINANCIAL ASSISTANCE PROGRAMS

2.28 Although the OMB is developing a system to identify recipients of federal assistance, referred to as the Federal Assistance Award Data System (FAADS), there is now no single centralized source for identifying all federal

⁷GAO's Standards for Audit, 26.

assistance. Nevertheless, the auditor should determine by tests and inquiries that the schedule of federal assistance is complete and contains all modifications. Thus, the auditor's procedures should include a review of contract files and subsequent receipts and disbursements. Such procedures would be similar to the procedures performed to search for unrecorded liabilities, unrecorded funds, and unrecorded bank accounts.

SUBGRANTEES (OR SUBRECIPIENTS) OF FEDERAL FINANCIAL ASSISTANCE PROGRAMS

2.29 A recipient of federal financial assistance that is subject to the requirements of the Single Audit Act is required to have its subrecipients of federal assistance that are state and local governments or Indian tribal governments adopt certain audit requirements. The Single Audit Act provides that a state or local government shall be considered to receive federal financial assistance whether such assistance is received directly from a federal agency or indirectly through another state or local government. The recipient that provides \$25,000 or more of such assistance to a subrecipient, as defined, is responsible for reviewing the subrecipient's audit, if one is conducted, and ensuring that prompt and appropriate corrective action is taken on instances of noncompliance with laws and regulations with respect to federal financial assistance provided. If the subrecipient does not have an audit conducted, the recipient shall determine that the expenditures of federal financial assistance passed through to subrecipients are in accordance with applicable laws and regulations and ensure that prompt and appropriate corrective action is taken on instances of material noncompliance with applicable laws and regulations. A discussion of subrecipient compliance and the recipient's responsibility for such compliance is contained in chapter 3.

2.30 Under the Single Audit Act, the auditor of the recipient is not required to conduct audits of subrecipients of federal financial assistance. The auditor is responsible for reviewing the recipient's system for (a) monitoring and disbursing funds to subrecipients and (b) obtaining and acting on the subrecipient's audit reports and should determine that the client's internal accounting control system provides reasonable assurance that payments to subrecipients are properly authorized and allowable under the terms and conditions of the federal financial assistance program. If such payments are significant, the auditor should test the internal accounting control system to determine that it is functioning in accordance with prescribed procedures and that there are effective controls over payments to subrecipients. The auditor should also test the procedures established to assure that subrecipients adhere to any audit requirements, that they submit audit reports to the proper organizations, and that the recipient takes the necessary corrective action indicated by the audit report. Other responsibilities of the auditor include commenting on the recipient's monitoring and disbursing procedures with respect to subrecipients, if warranted by the circumstances, and considering whether reported subrecipient questioned costs require adjustment of the recipient's financial statements, disclosure in the notes to the financial statements, or modification of the auditor's report.

STATE AND LOCAL GOVERNMENT AUDIT CONSIDERATIONS

2.31 Compliance with legal and regulatory requirements applies not only to federal financial assistance but also to state and local government assistance. For example, many state and local government statutes require audits to be conducted. Even though federal funding may be an important part of most state and local government budgets, much of a state's funding is derived from other sources. Thus, public officials are accountable not only to the federal government but also to their constituents, to other levels of government, to bondholders, and to other interested parties. Although the Single Audit Act does not require tests of compliance with nonfederal regulations, audits conducted in accordance with generally accepted auditing standards and the GAO's Standards for Audit may include such testing.

2.32 A significant aspect of any audit of a governmental unit is determining whether it has complied with applicable statutes. The specific audit requirements and objectives of a state or local government audit vary, and the statutes may not specify financial or compliance requirements.

2.33 Auditors should review the statutory, judicial, and constitutional documents as well as legal provisions and compliance requirements relating to the entity to be audited. The auditor should also review the governmental unit's laws, rules, regulations, and administrative policies. Auditors may wish to include copies of these documents in their permanent file.

2.34 The auditor should use professional judgment to determine the major compliance features to be tested. Examples of matters that may require compliance testing include the following:

- o Bond covenants
- o Purchasing procedures
- o Nonfederal grant requirements
- o Budgetary limits
- o Bank agreements
- o Legislative requirements
- o Expenditure restrictions
- o Tax limitations
- o Participant eligibility

2.35 Factors to be considered in determining major nonfederal compliance features to be tested include the materiality of funds involved, the potential effects of noncompliance on the financial statements, and any known weaknesses in the system of internal accounting control.

2.36 The process of identifying the programs, laws, and regulations to be tested and the performance of the tests are described in chapter 3.

BLOCK GRANT PROGRAMS

2.37 The Omnibus Budget Reconciliation Act of 1981 authorized nine block grant programs, replacing fifty-seven categorical grant programs. States have been given maximum flexibility, responsibility, and discretion for administering these programs, as required by the statutes and the implementing regulations.

2.38 As part of the delegation of responsibility, states are to ensure that financial and compliance audits of these block grant programs are conducted in accordance with the GAO's Standards for Audit. States may apply their own equivalent procedures for financial management and control of the programs in place of following the requirements contained in OMB Circulars A-87 and A-102. However, although block grant programs had separate audit requirements, the Single Audit Act supersedes such audit requirements and requires block grant programs to be included in the scope of a single audit.

DEFINITION OF THE REPORTING ENTITY

2.39 The reporting entity is the organization for which financial statements are normally prepared; it may be a political entity, for example, a state, city, county, or other political jurisdiction. In other instances, it may be an operating department, agency, or establishment of an entity that receives federal financial assistance for which annual financial statements are prepared.

2.40 The Single Audit Act provides that each audit conducted for any fiscal year shall cover the entire state or local government's operations except that, at the option of such government—

- o Such audit may (except each state or local government which, in any fiscal year of such government, receives directly from the Department of the Treasury a total of \$25,000 or more of general revenue-sharing funds shall not have the option) cover only each department, agency, or establishment which received, expended, or otherwise administered federal financial assistance during such fiscal year.
- o Such audit may exclude public hospitals and public colleges and universities.

2.41 If the defined entity does not regularly prepare general purpose financial statements but is a part of a political or governmental unit for auditing purposes, the entity would be "fractured." Thus, the auditor should consider whether the information being reported on constitutes complete financial statements or something less.

2.42 NCGA Statements 3 and 7 and Interpretation 7 provide criteria for defining the reporting entity for which financial statements should normally be prepared under generally accepted accounting principles. SOP 80-2 provides reporting guidance on the type of report that the auditor can issue, which

depends on the financial statements that a governmental unit presents and on the scope of the examination.⁸

2.43 The components of the reporting entity should be discussed with the cognizant agency in planning the scope of the examination.

DETERMINATION OF THE AUDIT PERIOD

2.44 A single audit should cover the reporting entity's financial statements prepared for its fiscal year, not for the period of the program funding. Thus, the examination might include only a part of certain assistance programs, since a portion of a program period might not fall within the period covered by the financial statements. Such a condition would apply equally to federal financial assistance received from other levels of government and non-governmental organizations.

2.45 If a state or local government's constitution, statute, administrative rules, regulations, guidelines, standards, or policies require audits less frequently than annually, the Single Audit Act provides that the cognizant agency shall, upon request of such government, permit the government to conduct biennial audits, which cover both years. After December 31, 1986, such audits must be made annually unless the recipient government codifies a requirement for biennial audits.

INITIAL-YEAR AUDIT

2.46 An auditor accepting, or contemplating accepting, an engagement wherein the financial statements of the preceding period were audited by another auditor should be guided by SAS No. 7, Communications Between Predecessor and Successor Auditors. However, if the financial statements have not been previously audited, the auditor should consider certain factors in conducting the initial audit. For example, if as of the beginning of the audit period the cumulative federal financial assistance receipts, expenditures, and cash balances have not been previously identified or audited, the auditor should adopt appropriate procedures to determine that the accounting principles are consistently applied to both the current year and the preceding year.

⁸The exposure draft of a proposed AICPA Audit and Accounting Guide, Audits of State and Local Governmental Units, specifies that the auditor's opinion on the general purpose combined financial statements is an opinion on each of the fund types and account groups, and the example reports provided in that draft make that clear. The implication is that audit scope and materiality evaluations should be determined on that basis. The original audit guide and SOP 80-2 discussed the auditor's opinions and provided examples that referred to the financial position and results of operations of the governmental unit "taken as a whole." The AICPA State and Local Government Accounting Committee believes the exposure draft is merely eliminating confusion over original intent. The reader may wish to refer to the exposure draft of the proposed AICPA Audit and Accounting Guide, Audits of State and Local Governmental Units, for additional information and discussion.

2.47 Where adequate records have been maintained by the recipient, it is usually practicable and reasonable to extend auditing procedures sufficiently in order to express an opinion on consistency as well as on the amounts of assets, liabilities, and fund balances, at the beginning of the current year.

2.48 Inadequate financial records or limitations imposed by the client may preclude the auditor from forming an opinion on the consistent application of accounting principles between the current year and the prior year, as well as on the amounts of assets, liabilities, and fund balances at the beginning of the current year. Where such amounts could materially affect current operating results, the independent auditor would also be unable to express an opinion on the current year's results of operations and changes in financial position. The auditor may need to perform additional auditing procedures to substantiate the opening balances and should consider this when planning the audit. Among the factors the auditor may wish to consider are—

- o The effectiveness of internal accounting controls, quality of financial records, overall materiality, and relative risk of potential award disallowances for the unaudited programs.
- o The ability to obtain sufficient evidential matter to test the receipts and expenditures applicable to awards relating to each of the financial statement areas.
- o The status of liabilities or revenues for completed or terminated contracts and awards.

2.49 For federal financial assistance programs, auditors should discuss with both the recipient and the cognizant agency, the alternatives available to them to determine the reasonableness of cumulative and opening balances. If certain alternative audit procedures are not performed or are impracticable, the auditor may issue a qualified opinion or disclaimer. For example, if the auditor is unable to obtain sufficient evidential matter on cumulative receipts and expenditures or on account balances of an earlier period, or is unable to adequately test compliance with legal and regulatory requirements for those programs with activities preceding the audit period, the auditor may be precluded from expressing an unqualified opinion. The auditor should refer to the applicable section of SAS No. 2 for guidance.

2.50 The auditor should consider giving special attention to any programs terminated during the audit period. Programs terminated before scheduled completion may result in termination claims and settlements that could affect the financial statements or federal financial reports. The auditor may wish to test grants or contracts completed during the year to determine compliance with the terms of the agreements and the possible existence of unrecorded liabilities or uncollectible receivables resulting from the closeout and final settlement. The auditor should also consider any subsequent events that may affect the financial statements required by SAS No. 1, section 560.

2.51 Since many of the above audit tests and procedures could affect the scope of audit work, the auditor should consider them in preparing the proposal and in planning the engagement. The auditor and the client should agree upon the scope of the engagement, and, if possible, it should also be reviewed by the cognizant agency.

Stub Periods

2.52 Although not required specifically by the Single Audit Act, auditors should give special attention in the initial year of a single audit to stub periods. Stub periods cover the time between the date of the most recently audited financial statements of separate federal financial assistance programs and the beginning of the period covered by the single audit. For example, the most recent separate program audit may be for the two-year period ended September 30, 19X0, whereas the single audit covers the period July 1, 19X1, through June 30, 19X2. In this example the unaudited stub period is October 1, 19X0, through June 30, 19X1. The auditor is well advised to consider in the planning phase whether stub period financial transactions and compliance activities need to be audited and should plan the scope of the engagement accordingly. In making this determination, the auditor should consider whether the stub period activity will have a material effect on the financial statements taken as a whole⁹ and on each major federal financial assistance program.

2.53 The auditor should discuss audit coverage of stub periods with the client, and the proposal should reflect whether stub periods will be audited and to what extent additional audit work may be required.

RELATIONSHIP WITH COGNIZANT AGENCY

2.54 Independent auditors should communicate with the cognizant agency before, during, and after the audit to avoid or minimize disagreements or other problems. The auditor may wish to inform the cognizant agency, through the recipient organization, of such matters as the audit plan, the scope of testing of the programs for specific compliance requirements, and whether he or she will use the OMB's Compliance Supplement for Single Audits of State and Local Governments¹⁰ (hereafter referred to as the OMB's Compliance Supplement), the overall sampling plan, and other audit matters, as deemed necessary.

2.55 If the cognizant agency disagrees with significant elements of the audit plan, those matters should be resolved among the recipient, the cognizant agency, and the auditor before any fieldwork is begun, and the audit plan should reflect agreed-upon changes. If an agreement cannot be reached, the auditor should inform the recipient that the cognizant agency may deem the final audit report not to be in accordance with the single audit objectives.

Responsibilities of Cognizant Agency

2.56 The OMB has designated cognizant audit agencies for state agencies and large local governmental units, and it has defined a process for determining cognizant agencies for other local governmental units.

⁹See note 8.

¹⁰U.S. Office of Management and Budget, Compliance Supplement for Single Audits of State and Local Governments (Washington, D.C.: U.S. Government Printing Office, 1982).

2.57 The responsibilities of designated cognizant federal agencies are determined by the OMB. Additionally, the JFMIP's Cognizant Audit Agency Guidelines¹¹ states that a cognizant agency shall do the following:

- o Maintain information regarding audit status for assigned recipient organizations.
- o Provide technical advice regarding organizationwide audits.
- o Obtain major compliance requirements in accordance with OMB policy for programs not included in the Compliance Supplement and transmit these to the auditor.
- o Inform affected agencies of irregularities uncovered.
- o Assure that audit reports are received, reviewed, and distributed.
- o Obtain or make quality assessment reviews of work of nonfederal audit organizations and determine significant inadequacies in the audit, if any, and notify the auditor, the recipient organization, and the appropriate professional bodies.

2.58 The auditor should not presume that conditions agreed to by the recipient and the cognizant agency for one engagement will be the same for other engagements, because cognizant agencies may decide to exercise their responsibilities differently.

2.59 Although each federal agency has agreed to exercise its cognizant responsibilities in accordance with policies set forth in the Cognizant Audit Agency Guidelines, that document is limited to broad policy statements and leaves the design and execution of specific procedures to the individual agencies. The Cognizant Audit Agency Guidelines provides guidance for promoting quality audits, processing audit reports, and providing notification of irregularities. Auditors should be familiar with its contents prior to conducting a single audit.

JOINT AUDIT CONSIDERATIONS

2.60 In conducting a single audit and in reporting on a governmental unit's financial statements and on its internal accounting controls and compliance, there may be instances when it will be necessary to engage the services of other auditors or to refer to the work of other auditors in a principal auditor's report. Although not mandated by the Single Audit Act, there may be instances where the audit could be performed by more than one auditor, such as in prime-subcontractor or joint-venture arrangements.¹²

¹¹Joint Financial Management Improvement Program, Cognizant Audit Agency Guidelines (Washington, D.C.: JFMIP, 1981).

¹²The exposure draft of the proposed Audit and Accounting Guide, Audits of State and Local Governmental Units, also contains a discussion of "Joint Examinations and Jointly Signed Reports."

2.61 The Single Audit Act and related OMB regulations provide guidance to federal recipients concerning opportunities for small business concerns and those owned and controlled by socially and economically disadvantaged individuals to participate in conducting single audits.

Part of an Examination Made by Other Independent Auditors

2.62 SAS No. 1, section 543, "Part of an Examination Made by Other Independent Auditors," discusses the guidelines for reporting on financial statements when part of an examination is made by other independent auditors. The principal auditor may assume full responsibility for the other auditor's work and may or may not refer to the examination of the other auditor in the principal audit report.

2.63 There are a number of situations wherein a part of a single audit may be performed by an independent auditor other than the principal auditor. For example, a governmental unit may receive assistance from the federal government and in turn provide a portion of such assistance to subrecipients. If the subrecipient's financial statements are examined by other auditors and payments made to subrecipients are significant in relation to the primary recipient's financial statements, the auditor of the primary recipient governmental unit will have to decide whether to refer in his report to the examination made by the other auditor. If the recipient's auditor does decide to refer to other auditors, he should follow the guidance in paragraph 7, SAS No. 1, section 543.

2.64 Another common situation involves examinations made by other auditors of a major component entity of the primary recipient government, such as a school district that is controlled by a city government. If the financial statements of the major component are examined by other auditors and are included in the financial statements of the recipient city government, the auditor of the primary recipient government will have to decide whether to make reference in his report to the examination made by the other auditors.

Joint Examinations

2.65 Governmental units sometimes engage consortiums of accounting firms to perform joint audit examinations of their financial statements. More than one accounting firm may jointly sign the audit report(s) and share the responsibility for the results of the examination in a partnership-type arrangement.

2.66 Joint signatures on an audit report indicate that all firms signing the report are responsible for the work performed, even though one audit firm normally has overall coordinating responsibility for the engagement and communications with the cognizant audit agency.

2.67 When undertaking a joint audit examination,¹³ the auditor is well advised to make inquiries concerning the professional reputation and

¹³ Although SAS No. 1, section 543, does not address joint audit engagements, the guidance in that section might also be useful for joint audits, and the auditor may wish to consider it.

independence of the other auditors. Those inquiries and other measures may include procedures such as—

- o Making inquiries of the AICPA, state societies, other practitioners, bankers, and other credit grantors regarding the reputation of the other auditor.
- o Obtaining a representation from the other auditor regarding the other auditor's independence.
- o Communicating with the other auditor about the other auditor's familiarity with generally accepted accounting principles, generally accepted auditing standards, GAO's Standards for Audit, and any special reporting requirements and his intent to conduct his examination accordingly.

Additional procedures might include¹⁴—

- o Visiting the other auditor to discuss the audit procedures followed and the results.
- o Reviewing the other auditor's audit program. In some cases, it might be appropriate to issue instructions to the other auditor regarding the scope of his audit work.
- o Reviewing the other auditor's working papers, including his evaluation of internal accounting control and his conclusions regarding other significant aspects of the engagement.
- o Having discussions with management about the component being audited.

2.68 Prior to conducting a joint audit examination, the joint auditors are well advised to have a formal agreement specifying the components of the financial statements to be examined by each, the rights and responsibilities to inspect each other's working papers, and the recourse that each auditor will have to the other for the potential liability that may result from the failure to properly perform the engagement.

2.69 An accounting firm may also be asked to conduct a joint examination with an independent governmental auditor.¹⁵ In these situations the firm should ensure that the government auditor meets all AICPA generally accepted auditing standards and those contained in the GAO's Standards for Audit.

2.70 Certain key elements that the auditor may wish to consider before entering into an audit subcontract or joint-venture agreement are listed in

¹⁴ Auditing interpretation, "Application of Additional Procedures Concerning the Other Auditor's Examination" (AU sec. 9543.18), provides further guidance in this area.

¹⁵ As described in the GAO's Standards for Audit, internal auditors may not be considered by third parties to be independent of the entity while conducting an audit within their own organizations.

exhibit 2-1. When more than one firm is conducting an audit, the client, the auditors, and the cognizant agency should clearly understand and agree to the division of responsibility as set forth in a written contract.

FORMALIZING THE ENGAGEMENT ARRANGEMENT

2.71 Generally, governmental audit agreements are formal, written contracts that are legally enforceable and difficult to change once executed. In formalizing the engagement, the auditor should communicate his understanding of the client's audit requirements and any additional requirements of the cognizant agency or state or local government. Informal understandings or arrangements are not desirable and should be avoided if possible; therefore, the basic scope of audit work, as well as additional requirements and modifications, should preferably be in writing.

2.72 The Western Intergovernmental Audit Forum, a consortium of federal, state, and local governmental auditors in the western states, suggests items to be included in a request for a proposal to conduct a governmental audit. Several of the key requirements are enumerated in exhibit 2-2. If this information is not provided by the requestor, the auditor should use his professional judgment in determining whether to request the missing items.

**SUGGESTED ELEMENTS THAT MAY BE INCLUDED
IN SUBCONTRACT OR JOINT-VENTURE AUDIT AGREEMENTS**

1. Period of performance of the contract
2. Specific working papers or reports to be delivered and due dates for completion
3. The specific personnel mix, qualifications, and level of effort of key individuals, as well as an indication of the amount of supervision to be provided
4. The hourly rate, by class of auditor, and the level of commitment for each class
5. The payment/billing terms and the provision for allocation of indirect costs, if any
6. The method of terminating the agreement and the ways to arbitrate disputes
7. A provision for retaining working papers
8. Details of each firm's responsibilities for the examination of the financial statements of the various components of the entity if separate statements are prepared
9. Reporting responsibilities of auditors

Note: Since the principal auditor's responsibilities differ in joint ventures and subcontract arrangements, the structure of the agreement could vary.

**SELECTED ITEMS ORDINARILY COVERED
IN REQUESTS FOR PROPOSALS FOR GOVERNMENT AUDITS**

1. The requestor's address and the recipient of the proposal
2. A description of the entity and the records to be audited, including general information such as type of government, population figures, and budget size; magnitude of the financial activity; basis of accounting used during the year and at year-end; description of budget records and how revenues, expenditures, and encumbrances are recorded in the accounting records; description of other systems, records, and procedures, including those pertaining to federal financial assistance programs
3. A list of grants and amounts, subgrantees, funds, account groups, functions, or activities to be audited
4. A statement specifying which of the following types of examinations is required and any special scope requirements: examination of financial statements; review of internal accounting control as a part of an audit of financial statements; examination of compliance with pertinent laws, regulations, contracts, and so on; examination conducted in accordance with generally accepted auditing standards, and the GAO's Standards for Audit
5. Availability of prior years' audit reports and management letters
6. Identification of the cognizant audit agency
7. Involvement, if any, with subgrantees
8. The period to be audited
9. A provision for identification of the source of compliance requirements
10. Definition of reporting requirements (comprehensive annual financial report, general purpose financial statement, or special reports)
11. Specification of whether, and with whom, exit conferences are to be held
12. The availability of prior years' reports
13. The amount of assistance available to the proposers and whether the requestor's staff will be available to assist the proposer
14. The place, date, and time of the proposer's conference
15. Time considerations and requirements
16. The contractual arrangements, including payment terms

Exhibit 2-2 (cont.)

17. Retention and availability of working papers
18. The auditor selection process
19. The auditor evaluation criteria
20. The information specifically required to be furnished in the proposal
21. The proposal due date
22. Other auditor responsibilities

CHAPTER 3

PERFORMING THE AUDIT

3.1 This chapter discusses the study and evaluation of internal accounting controls, audit sampling, and other auditing tests and procedures that the auditor should consider in conducting a single audit.

3.2 The single audit requirements extend beyond the AICPA's generally accepted auditing standards and procedures. For example, tests of compliance with applicable laws and regulations are more extensive than tests normally performed during examinations of the financial statements of nongovernmental organizations. The Single Audit Act also establishes reporting requirements relating to reviews of compliance with laws and regulations and internal accounting control.

3.3 As suggested earlier, the auditor should consider the additional requirements in planning an effective and comprehensive audit program; in reviewing, testing, and evaluating internal accounting controls and compliance with applicable laws and regulations; in performing substantive tests of transactions; and in determining the appropriate form of reporting.

STUDY AND EVALUATION OF INTERNAL ACCOUNTING CONTROLS

3.4 Among other provisions, the Single Audit Act requires that each audit shall determine and report whether the government, department, agency, or establishment has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. The amount of testing and the required determinations are to be based on the professional judgment of the independent auditor.

3.5 The GAO's Standards for Audit and the AICPA's generally accepted auditing standards require a proper study and evaluation of the existing systems of internal accounting control as a basis for reliance thereon and for determining the resultant extent of the tests to which auditing procedures are to be restricted.

3.6 SAS No. 1, section 320, "The Auditor's Study and Evaluation of Internal Control," defines accounting controls and administrative controls and states that the auditor is primarily concerned with the accounting controls or those administrative controls having a direct bearing on the reliability of the financial statements.

3.7 Governmental entities may have established controls to ensure compliance with legal or regulatory requirements, which may be considered more in the nature of administrative controls. Those controls have a direct bearing on the reliability of the financial statements because failure to comply with legal or regulatory requirements could have a material effect on the financial statements and major federal financial assistance programs; the auditor is required by the GAO's Standards for Audit to report on their study and

evaluation of internal controls made as part of the financial and compliance audit.

Controls Evaluated

3.8 The Single Audit Act requires the auditor to determine and report whether the government, department, agency, or establishment has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. The auditor is not required to render an opinion on the recipient's internal control systems over its federal financial assistance programs.

3.9 The Single Audit Act defines internal controls as "the plan of organization and methods and procedures adopted by management to insure that—

- (A) resource use is consistent with laws, regulations, and policies;
- (B) resources are safeguarded against waste, loss, and misuse; and
- (C) reliable data are obtained, maintained, and fairly disclosed in reports."¹

3.10 The GAO's Standards for Audit requires a report on significant internal accounting controls. The report should identify those controls (or categories of controls) evaluated and those not evaluated and the material weaknesses identified as a result of the evaluation. Although the reporting requirements of the GAO's Standards for Audit exceed the requirements of SAS No. 30 by requiring significant controls to be identified, the procedures do not exceed generally accepted auditing standards. The GAO's Standards for Audit specifically states that the reporting requirements for internal accounting controls do not require any additional audit effort other than that required as part of a normal financial and compliance audit.

3.11 The GAO's Standards for Audit states that the requirement to identify an entity's significant internal accounting controls may be satisfied by identifying significant classes of transactions and related assets. The transactions may be grouped in a variety of ways, depending on the nature of the entity and the circumstances of the engagement. Appendix C is Report Required by U.S. General Accounting Office--An Auditing Interpretation of SAS No. 30, Reporting on Internal Accounting Control. It provides guidance to the auditor on how to identify and classify accounting controls and how the report in SAS No. 30 should be modified to include those representations.

3.12 The GAO's Standards for Audit states that there are a number of reasons why a study and evaluation of internal accounting control may not be made, including three specific reasons: (1) the entity is so small that it is not feasible to have an adequate internal control system; (2) the auditor concludes that it is more efficient to expand substantive tests and place very little reliance on internal accounting control; and (3) the existing internal control system may contain so many weaknesses that the auditor has no choice

¹Section 7501 of the Single Audit Act.

but to rely on substantive testing, thus virtually ignoring the internal control system. Regarding the expansion of substantive tests, SAS No. 1, section 320.53, states that a similar conclusion might result from consideration of the nature and amount of transactions and account balances involved, the data processing methods used, and the efficiency of extending the auditing procedures that can be applied in making substantive tests.

3.13 Paragraph 2 of SAS No. 43, Omnibus Statement on Auditing Standards, clarifies the minimum study and evaluation of the system of internal accounting control contemplated by the second standard of fieldwork by stating that the review of internal accounting control may be limited to obtaining an understanding of the control environment and the flow of transactions. It also states that if the auditor does not plan to rely on the system of internal accounting control to restrict substantive tests, his documentation may be limited to a record of the reasons for deciding not to extend the review.²

3.14 However, the Single Audit Act requires a determination that the government, department, agency, or establishment has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. In the unlikely event that there is only one system operated to ensure compliance with federal financial assistance requirements, the auditor would study and evaluate that system. As is usually the case, however, federal financial assistance programs are administered by several organizational components within the recipient entity government, and each component usually maintains a separate or different system for ensuring compliance. In those situations the auditor would study and evaluate each of the systems.

3.15 Furthermore, although the systems for ensuring compliance with applicable laws and regulations might appear effective based on the aforementioned minimum study and evaluation, the auditor needs to obtain assurance that the controls within the systems are functioning as prescribed. The auditor obtains such assurance by testing transactions processed within those systems for adherence to the prescribed procedures.

Reporting Material Weaknesses

3.16 As stated in paragraph 3.8, the Single Audit Act requires the auditor to determine and report whether the government, department, agency, or establishment has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations.

3.17 The auditor is not required to render an opinion on the recipient's internal control systems over its federal financial assistance programs.

²The auditing interpretations of SAS No. 30, Reporting On Internal Accounting Control, provide reporting guidance for situations when a study and evaluation is not made beyond the minimum level required by SAS No. 43 and when auditors are required by law to address their reports to legislative bodies and the public.

However, the auditor's report on the study and evaluation of the systems should identify, at a minimum, the controls in place and studied, the material weaknesses found, and the controls not relied on and the reasons therefor. The report should provide sufficient information to permit federal, state, and local officials to judge whether the controls in place provide reasonable assurance that the recipient is managing federal financial assistance programs in compliance with applicable laws and regulations.

3.18 The GAO's Standards for Audit also requires to report the material weaknesses identified as a result of their study and evaluation of internal accounting controls made as part of the financial and compliance audit.

3.19 SAS No. 20, Required Communication of Material Weaknesses in Internal Accounting Control, states that material weaknesses may become known to the auditor through his initial review of the system, through testing compliance with the system, or through performing substantive tests of transactions and accounts. Similarly, for single audit purposes, all material weaknesses that have come to the auditor's attention during the audit, regardless of how identified, should be reported by the auditor.

AUDITING CONSIDERATIONS

3.20 Federal financial assistance is defined broadly in the Single Audit Act to include assistance provided by a federal agency in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations. The term does not include direct federal cash assistance to individuals.

3.21 Although there is no requirement for the auditor to test all federal financial assistance programs, the Single Audit Act does contain specific audit requirements for major federal assistance programs, as defined.

Major Federal Assistance Programs

3.22 Under the Single Audit Act, each audit shall determine and report on whether the recipient has complied with laws and regulations that may have a material effect upon each major federal assistance program. The Single Audit Act defines a major federal assistance program as any program for which total expenditures (not receipts) of federal financial assistance during the applicable year exceed—

- o \$20 million in the case of a state or local government for which such total expenditures for all programs exceed \$7 billion.
- o \$19 million in the case of a state or local government for which such total expenditures for all programs exceed \$6 billion but are less than or equal to \$7 billion.
- o \$16 million in the case of a state or local government for which such total expenditures for all programs exceed \$5 billion but are less than or equal to \$6 billion.

- o \$13 million in the case of a state or local government for which such total expenditures for all programs exceed \$4 billion but are less than or equal to \$5 billion.
- o \$10 million in the case of a state or local government for which such total expenditures for all programs exceed \$3 billion but are less than or equal to \$4 billion.
- o \$7 million in the case of a state or local government for which such total expenditures for all programs exceed \$2 billion but are less than or equal to \$3 billion.
- o \$4 million in the case of a state or local government for which such total expenditures for all programs exceed \$1 billion but are less than or equal to \$2 billion.
- o \$3 million in the case of a state or local government for which such total expenditures for all programs exceed \$100 million but are less than or equal to \$1 billion.
- o The larger of \$300 thousand or 3 percent of such total expenditures for all programs, in the case of a state or local government for which such total expenditures for all programs exceed \$100 thousand but are less than or equal to \$100 million.

3.23 The Single Audit Act requires the auditor to select and test a representative number of transactions from each major federal assistance program. The number of transactions selected and tested is based on the auditor's professional judgment, considering such factors as:

- o The amount of expenditure for the program and individual awards
- o The newness of the program or changes in its conditions
- o Prior experience with the program, particularly as revealed in audits and other evaluations (for example, inspections, program reviews)
- o The extent to which the program is carried out through subrecipients
- o The extent to which the program contracts for goods or services
- o The level to which the program is already subject to program reviews or other forms of independent oversight
- o The adequacy of the controls for ensuring compliance
- o The expectation of adherence or lack of adherence to the applicable laws and regulations
- o The potential effect of adverse findings

Nonmajor Assistance Programs

3.24 No specific testing requirements are mandated by the Single Audit Act for nonmajor federal assistance programs. However, if transactions from nonmajor programs are selected for testing as part of the audit of the financial statements, such transactions should be tested also for compliance with federal laws and regulations that apply to such transactions, for example:

- o If an auditor examined a payroll transaction that was charged to a nonmajor program, the auditor would determine that the individual was employed during the period; that the position could reasonably be charged to the program; that the individual was paid the correct salary for the position; and that the individual's salary was correctly charged to the program. The auditor would not be required to test for general compliance with civil rights, Davis-Bacon, or other cross-cutting provisions.
- o If the auditor examined a travel claim that was charged to a nonmajor program, the auditor would determine whether the person who performed the travel worked on the program; whether administrative travel was an allowable charge to the program; and whether the travel allowances were within administratively prescribed limits. The auditor would not be required to test the transactions for compliance with relocation or cash management limitations.
- o If the auditor examined a payment to a subrecipient, the auditor would determine whether the payment to the subrecipient was to carry out the purpose of the program and whether the grantee had a system in place to monitor the subrecipient's compliance with program provisions. The auditor would not be required to determine if the federal financial reports were prepared for the program.
- o If the auditor examined a program-related payment made directly to an individual or organization, the auditor would determine whether the payment was for the purposes intended by the program and for allowed services and whether the individual or organization was eligible. The auditor would not be required to test for the program's overall compliance with such features as civil rights, cash management, and federal financial reports.

3.25 With respect to the transactions selected and tested for nonmajor programs, any noncompliance found in such transactions shall be reported.

Tests of Compliance With Laws and Regulations

3.26 The GAO's Standards for Audit defines compliance as—

A determination of whether (1) there is compliance with laws and regulations that could materially affect the entity's financial position and statements, (2) there is compliance with the laws and regulations that could significantly affect the acquisition, management, and

utilization of the entity's resources, and (3) programs are being carried out in conformity with laws and regulations.³

3.27 In a single audit, auditors perform tests of compliance of major federal assistance programs to determine that the organization, program, function, or activity under audit has not violated applicable laws and regulations that could have a material effect on the recipient's financial position and results of operations, and on each major federal assistance program. Readers of the audit report want to know whether funds were spent for the purposes authorized, within the budgeted amounts, and within the authorized time period. Grantors are concerned with obtaining reasonable assurance that the recipient is complying with legal and regulatory requirements.

Transaction Testing Considerations

3.28 In connection with the auditor's tests of major federal assistance programs, the auditor may wish to consider the following.

3.29 Are the charges necessary and reasonable for the proper administration of the program? The purpose, authorization, and timing of transactions should be examined in relation to whether such transactions are of a type generally recognized as ordinary, prudent, relevant, and necessary within established practices. For example, necessary costs would include expenditures for goods or services for the program being charged, in quantities that would be considered normal for the nature of the activities conducted, and at a price that is competitive. Federal agencies have defined reasonable costs as those costs, by nature and amount, that would not exceed the costs incurred by the ordinarily prudent person in the conduct of a competitive business. The provisions of the OMB Circular A-87, Cost Principles Applicable to Grants and Contracts with State and Local Governments, which defines numerous allowable costs, unallowable costs, and costs requiring approval of federal grantors, are particularly useful in making these determinations.

3.30 Do the charges conform to any limitations or exclusions in the federal assistance agreement? Costs associated with violations of the terms and conditions of a program should be classified as questionable by the auditor regardless of whether they meet other criteria of the program. For example, one federal program may limit the amount of indirect costs that may be charged to it; another program may permit charging only direct costs to the program, including some that might otherwise be included as indirect costs. Further, the client may have agreed that certain costs should be considered as unallowable as a charge to the program. Costs that are contrary to the conditions of a specific program or contrary to federal government policy or law is a reportable event.

3.31 Were the charges given consistent accounting treatment and applied uniformly to both federally assisted and other activities of the recipient? Consistency relates to applying the same accounting treatment in a similar manner to similar transactions within an accounting period and from one reporting period to another. Additionally, the accounting methods and practices should

³GAO's Standards for Audit, 64.

be the same and uniformly applied to both federal and nonfederal activities within and between reporting periods.

3.32 Were the charges net of applicable credits? Federal programs should be charged for the actual net cost or net cash disbursed. The phrase "net of applicable credits" refers to credits that normally offset or reduce cost categories as, for example, rental income, sale of assets purchased with grant funds, fees from sale of goods, trade-ins, volume discounts, refunds and other credits, and trade or cash discounts.

3.33 Were costs charged only to the applicable federal assistance programs? In determining properly chargeable costs, generally both direct and indirect, OMB Circular A-87 requires that the following factors be considered: reasonableness, allocability, the application of appropriate generally accepted accounting principles, and any limitation or exclusions set forth in the federal assistance agreement relating to types or amounts charged. Within the federal government, a cost is assignable or chargeable to a particular cost objective (grant, contract, project, activity, process, or service) based upon (a) a direct charge according to the benefits received or other equitable relationship, (b) an allocation that may benefit more than one cost objective, or (c) indirect allocation to all cost objectives, since a direct relationship to any particular cost objective cannot be shown although the cost is necessary to the overall operations of the organization. The OMB Circular A-87, Cost Principles Applicable to Grants and Contracts With State and Local Governments, requires that programs be charged with only those costs applicable to that program.

3.34 Were the charges properly recorded (i.e., correct purpose, amount, date) and supported by source documentation? The preceding five paragraphs discuss some factors that the auditor may wish to consider in determining whether charges were properly recorded. To determine whether recorded charges are supported by source documentation, the auditor should examine the evidential matter supporting the charge selected for testing. Documentation should support that the type of cost is allowable under and within the period of the federal assistance, that the purpose and the amount of costs are proper (itemized to the extent necessary), and that all approvals are in accordance with management's directives. For example, for construction payments, the auditor should determine that the quantities were properly measured and documented in accordance with the terms of the construction contract specifications or the amounts paid for land acquisition are supported by professional appraisals and properly reviewed. Normally, the auditor is not required to evaluate technical matters but rather to determine that proper technical personnel were employed to compute and review the basis for payments and that the basis is properly documented.

3.35 Were the charges approved in advance, if subject to prior approval in accordance with Circular A-87? OMB Circular A-87, Cost Principles Applicable to Grants and Contracts with State and Local Governments, indicates that prior approval is required for several specific types of expenditures, such as rental cost, capital expenditures, insurance, and professional services. In addition, the federal financial assistance agreement, itself, may require advance approval for other specific costs. The auditor should read the award agreement and should test the charges to obtain satisfaction that the

recipient is complying with OMB Circular A-87 and the specific federal assistance requirements.

3.36 Were the charges incurred in accordance with competitive purchasing procedures, if covered by Attachment O of OMB Circular A-102? Attachment O relates to procurement standards and establishes standards and guidelines for the procurement of supplies, equipment, construction, and services for federal assistance programs and provides for procurement by small-purchase procedures, competitive negotiation, or noncompetitive negotiation. The auditor should test the organization's purchasing procedures for compliance with requirements of Attachment O. Procurement procedures conforming to state and local laws and regulations may be used provided that procurements for federal assistance programs conform to the standards of Attachment O.

3.37 Were the charges allocated equitably to benefiting activities, including nonfederal activities? The entity should apply the provisions of OMB Circular A-87 for allocating indirect costs benefiting federal and nonfederal activities. A later section on indirect costs describes additional factors relating to the allocation of indirect costs.

Tests of General and Specific Compliance Requirements

3.38 To assist the independent auditor in determining which federal compliance requirements should be tested, the OMB published the Compliance Supplement, specifying the general and the specific program compliance requirements for major federal assistance programs.

3.39 Under the Single Audit Act, the auditor is to determine what laws and regulations have a material effect on each major federal financial assistance program and on the financial statements. Congress is clear in its intent that although the auditor may find the Compliance Supplement useful guidance, its use is not mandatory; the supplement may be used, but need not be.

3.40 General Requirements for Compliance Testing. The OMB's Compliance Supplement provides compliance requirements and suggested audit procedures for the general features applicable to many, but not all, federal financial assistance programs. The auditor should be alert for possible violations of any of the compliance requirements throughout the engagement. If the auditor discovers a violation of one or more of the following general requirements applicable to the assistance program being tested, he is well advised to consider disclosing the violation in the auditor's comments on compliance and consider the effect, if any, on the financial statements and on each major federal assistance program.

- o Political Activity (Hatch Act and Intergovernmental Personnel Act of 1970, as amended). These acts specify that federal funds cannot be used for political activity of any kind. This general prohibition applies to all federal assistance programs.
- o Construction Contracts (Davis-Bacon Act). All construction programs are required to follow the provisions of the Davis-Bacon Act, which in general requires that laborers and mechanics employed by contractors of federally funded projects be paid at wages not less than those

established by the secretary of labor (for example, the prevailing regional union wage rate).

- o Civil Rights. Federal aid programs provide that no person shall be excluded from participation in, or be subjected to discrimination in, any program funded, in whole or in part, by federal funds because of race, color, national origin, sex, age, or physical impairment.
- o Cash Management. Many recipients receive funds through a letter of credit arrangement with the grantor agency. Cash should be withdrawn only in amounts necessary to meet immediate needs or to cover program disbursements already made.
- o Relocation Assistance and Real Property Acquisition. Federal assistance programs may require the acquisition of property by a public agency and subsequent displacement of households and businesses.
- o Federal Financial Reports (OMB Circular A-102, Attachment H). Attachment H requires that recipients of federal assistance file four financial reports for each federal assistance program. A separate section of this guide discusses the review of federal financial reports.

3.41 Suggested audit procedures for all of these general compliance requirements are also included in the OMB Compliance Supplement. The auditor should use professional judgment in deciding whether to perform additional or alternative tests and procedures to determine the adherence or lack of adherence to a general requirement.

3.42 Specific Program Requirements for Compliance Testing. The OMB Compliance Supplement also provides a comprehensive list of specific program requirements (specific compliance requirements) and suggested audit procedures for many assistance programs.

3.43 In addition to performing tests and procedures of general compliance requirements, the auditor, exercising professional judgment, should identify, evaluate, and test those controls and systems established to provide reasonable assurance that the individual program requirements are being monitored by management. For example, the auditor should perform tests and procedures of those established controls to monitor the eligibility requirements of persons or organizations to which the recipient has agreed to disburse funds. In other cases, where applicable, controls relating to compliance with matching share agreements should be tested. The specific requirements are organized into the following five categories:

1. Types of service allowed or unallowed
2. Eligibility
3. Matching, level of effort, and earmarking
4. Reporting
5. Special tests and provisions

3.44 The OMB, in its Compliance Supplement, recognizes that although there may be other compliance requirements for federal assistance programs, the auditor, using professional judgment, may consider whether to perform tests of compliance with those other requirements. The OMB has stated that other (non-audit) means are used to obtain assurance of compliance with those other requirements, and federal agencies have determined that, in general, noncompliance with those requirements would not materially affect the recipient organization's financial statements.

3.45 Although each requirement in the Compliance Supplement is accompanied by suggested audit procedures that can be used to test for compliance with laws and regulations, the audit procedures are not the only ones that an auditor may use. The Single Audit Act permits auditors to exercise professional judgment and to use any procedure necessary to determine adherence to laws and regulations if such procedures support the auditor's comments regarding compliance or noncompliance with the specified requirements.

3.46 If the auditor decides not to use the Compliance Supplement, he is well advised to identify and extract the equivalent significant compliance requirements from the assistance agreement, statutes, or the individual federal grantor agency's regulations. The auditor may wish to provide the cognizant agency the opportunity to review the specifications of these requirements. The auditor should consider those compliance requirements that, if violated, could have a material effect on the financial position and results of operations of the entity and on each major federal assistance program. The significant compliance requirements generally relate to the following:

- o Types of services allowed or not allowed
- o Program recipient's eligibility for groups to whom federal funds are disbursed
- o Compliance with any matching, level-of-effort, or earmarking requirements
- o Reporting and special requirements
- o Special tests and provisions

SPECIAL CONSIDERATIONS

Compliance Requirements of State Programs

3.47 State agencies may have programs with compliance requirements that the auditor may need to consider in conducting a single audit. For example, a state government may redistribute federal financial assistance (pass-through awards) to other local governments, or it may provide assistance from state resources and add its own compliance requirements to the awards. Some of the requirements more frequently encountered deal with tax limitations, expenditure limitations, debt limitations, establishment of specific funds, and the manner in which certain accounting activities may be performed. The single audit may also encompass state financial assistance. If state program

compliance requirements are to be included in a single audit, they should be identified by reviewing relevant assistance agreements and state regulations before beginning the audit. The auditor should consider addressing state compliance requirements in the audit contract.

3.48 State program compliance requirements generally relate to administrative matters and apply to individual program terms and conditions. If the auditor is to test state compliance requirements, he should identify and evaluate the control systems established for monitoring pass-through funds and should audit such funds as though they were received directly from the sponsoring organization; that is, federal compliance requirements apply to federal funds and state compliance requirements apply to state funds.

Subrecipient Compliance

3.49 Many governmental units have subcontract or subgrant awards and disburse their own funds, as well as federal funds, to subrecipients such as to governmental and private organizations to perform activities specified in award agreements. In many instances, the amount of these subgrants, subcontracts, or other payments may be material to the primary recipient's financial statements.

3.50 Since noncompliance by a subrecipient could result in questioned costs to the recipient, the auditor should study and evaluate the controls established to monitor compliance by subrecipients and should include payments to subrecipients as part of the test of transactions. The auditor also should consider reviewing for noncompliance with laws and regulations available audit reports and related management letters received by the recipient from subrecipients in order to ascertain any possible material effects on the recipient's financial position and results of operations and on each major federal assistance program. The specific comments contained in the subrecipient's audit reports that have been reviewed do not have to be included in the primary recipient's audit report. However, the auditor should consider transactions or events of the subrecipient that could have a material effect on the financial position, and on each major federal assistance program of the primary recipient or indications of material weaknesses in the monitoring system or other noncompliance matters, and should consider disclosing such matters.

3.51 With respect to subrecipient compliance, under the requirements of the Single Audit Act, if a recipient entity receives federal financial assistance and provides \$25,000 or more of such assistance to a subrecipient, the recipient entity is responsible for determining that the expenditures of federal monies passed through to subrecipients are in accordance with applicable laws and regulations. This responsibility may be discharged by relying upon independent audits performed for the subrecipients, relying on appropriate procedures performed by the recipient's internal audit or program management personnel, expanding the scope of the independent financial and compliance audit of the recipient to encompass testing of subrecipients' charges, or a combination of these procedures. The recipient entity is responsible for reviewing audit and other reports submitted by and for subrecipients and identifying questioned costs and other findings pertaining to the federal financial assistance passed through to the subrecipients, and properly accounting for and pursuing recovery of questioned costs and ensuring that prompt and appropriate

corrective action is taken on instances of material noncompliance with laws and regulations applicable to federal financial assistance passed through to the subrecipients. Additionally, each recipient entity shall require each subrecipient of federal financial assistance to permit, as a condition of receiving funds from such assistance, the independent auditor of the recipient entity to have access to the subrecipient's records and financial statements.

Review of Federal Financial Reports

3.52 In the evaluation of systems established to ensure compliance with applicable laws and regulations the auditor may wish to consider whether the federal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the basic financial statements have been prepared. The auditor should consider reviewing the financial data in the federal financial reports to determine if the information is presented in accordance with Attachment H, "Financial Reporting Requirements," of OMB Circular A-102.

3.53 Attachment H describes the following reports that should be prepared by recipients and submitted to the federal government:

- o Financial status report
- o Federal cash transactions report
- o Request for advance or reimbursement
- o Outlay report and request for reimbursement for construction programs

3.54 Individual federal assistance agreements contain the specific reporting requirements that the recipient is required to follow. However, Attachment H establishes the standard financial reporting requirements for all federal assistance programs. Auditors may wish to familiarize themselves with the detailed instructions and the client's system for preparing and submitting federal financial reports.

3.55 A separate auditor's opinion on federal financial reports is not required by the Single Audit Act. However, as part of the compliance comments, the auditor may wish to comment on the federal financial reports. As a basis for those comments on the federal financial reports, the auditor may wish to examine a representative sample of reports from material grant awards that pertain to the major federal assistance programs selected in order to test for compliance or noncompliance with applicable laws and regulations. The data from these reports should be traced to the underlying records on a test basis. An illustration of those comments is presented in chapter 5.

Indirect Costs

3.56 A portion of a recipient's total operating costs may be charged to federal and other grant programs in the form of indirect costs. To be eligible for reimbursement under federal programs, indirect costs should be allocated in accordance with the requirements of a formal cost allocation plan, which

may require periodic negotiation and approval by a designated federal agency responsible for indirect cost determinations.

3.57 State agencies and certain nonprofit organizations are required to submit their indirect cost plans to a designated federal agency (indirect cost cognizant agency) for approval. Allowable indirect cost rates may vary by agency or program. Generally, local (municipal) entities are not required to submit their indirect cost plans to a cognizant audit agency⁴ for approval; however, the cognizant agency may request it.

3.58 Indirect costs can be a significant portion of total federal expenditures, may affect many financial transactions and accounts, and may be material in relation to the financial statements taken as a whole.⁵ Under federal regulations, total costs of an entity include both direct costs and allocable indirect costs less applicable credits. Basically, direct costs are those that can be identified specifically with a particular cost objective. Indirect costs are (a) those incurred for a common or joint purpose benefiting more than one project, award, contract, or cost objective and (b) those not readily assignable to the cost objectives specifically benefited. Indirect costs may apply to other departments within the organization in supplying goods, services, and facilities. Additionally, minor direct cost items may be considered to be indirect costs for practical reasons.

3.59 The cost principles governing the allowability and reimbursement of costs under governmental awards are set forth in OMB Circular A-87. A synopsis of this circular is included in Appendix B to this guide. The overall purpose of the cost principles is to ensure that federal assistance programs are charged with a reasonable amount of allowable costs. To be reimbursed for indirect costs, an entity should prepare and retain an indirect cost allocation plan or proposal that provides the basis for the establishment of an indirect cost rate (provisional, fixed, negotiated, and so on). The plan should contain a list of the cost to be allocated and the basis or method(s) used for such allocation. In addition, the entity may also prepare a second plan, a central service cost allocation plan, covering the allocation of central administrative or support costs to major governmental service departments or programs that support or benefit the entity's activities.

3.60 If indirect costs are charged in accordance with an approved plan, auditors should test and examine the costs charged to the indirect cost pool and determine that the indirect costs were accumulated in conformity with the approved plan. Auditors should also satisfy themselves that such costs were not charged directly to other projects and that the indirect cost rate being applied agrees with the rate in the approved plan.

⁴Although the Single Audit Act refers to a cognizant agency, cognizant agencies have also been designated by the OMB for indirect cost responsibilities. Single audit cognizance and indirect cost cognizance may not necessarily rest with the same agency.

⁵See note 8, page 22.

3.61 If indirect costs are charged through a plan that has not yet been approved, the auditor should examine supporting documentation to determine whether—

- o The indirect costs can be reconciled to the financial statements or books of accounts.
- o The methods of allocating costs are in accordance with guidelines provided in OMB Circular A-87.
- o Costs are not treated as indirect costs and also charged directly to projects.
- o Statistical data (for example, square footage, population, salaries) included in the proposed bases are current and reasonable.
- o The costs are reasonable in amount and properly allocable.
- o The indirect cost pool contains only items that are consistent with the applicable cost principles.
- o The proposed costs were incurred within the period under review.

3.62 If the auditor detects errors in an approved indirect cost plan, those errors should be discussed with the appropriate level of management. Such errors may include, but are not limited to, mathematical inaccuracies, improper application of cost accounting practices, management oversight, other factors affecting the calculated indirect cost rate, or misuse of facts that existed at the time the plan was prepared. If the auditor considers such errors to be significant, they should be discussed with the cognizant agency or agencies assigned for the single audit and indirect cost purposes.

3.63 A deficient indirect cost plan or the absence of such a plan could materially affect the financial statements or federal financial reports if indirect costs are charged to the award. Identified adjustments in the indirect cost plan and any errors in an approved plan should be included in the auditor's compliance comments.

3.64 Although not a federal policy, some federal agencies have taken the position that if an indirect cost proposal is submitted late, indirect costs previously reimbursed may be disallowed; and if funds are awarded in a period where an indirect cost rate does not exist, indirect costs may not be reimbursed. Those agencies believe that even when a rate is later established, based on a late plan submission, indirect costs will only be reimbursed from the first day of the month in which a proposal was submitted. Under such conditions, a substantial adjustment to the financial statements or federal financial reports may be necessary for the amounts claimed for allowable program expenditures.

Criteria for Questioning Costs

3.65 The criteria established for questioning costs charged to or claimed under federal government programs varies from one agency to another. Many of

the criteria are imposed by Congress at the time the program is authorized and funds are provided; other criteria are established through agency regulations. Generally, the criteria for questioning costs relate to the following categories:

- o Unallowable Costs. Certain costs are specifically unallowable under the general and special award conditions or agency instructions. (They include pregrant and postgrant costs, travel or per diem costs in excess of federal rates, and other expenditures in excess of the approved award budget.)
- o Undocumented Costs. Costs charged to the award for which adequate detailed documentation does not exist to demonstrate the relationship to the award, the amount, the purpose or the time periods involved.
- o Unapproved Costs. Costs that are not in the approved budget, or costs for which the award/contract provisions or applicable cost principles require the awarding agency's approval, but for which the auditor finds no evidence of approval.
- o Unreasonable Costs. Costs incurred that may not reflect the action that a prudent person would take under the circumstances or assigning an unreasonably high valuation to in-kind contributions.

3.66 Although criteria for questioning costs may vary with the program and the specific conditions of the award agreement, federal grantors and agencies often retain historical records of the type of costs questioned. The auditor may wish to consider reviewing these records to determine whether corrective action concerning questioned costs has been planned or taken by the agency.

3.67 Based on the criteria established for questioning costs and the tests performed on the samples selected, the auditor should report in the schedule of findings and questioned costs all questioned costs identified.

3.68 The GAO's Standards for Audit requires that the auditor's report contain a statement of positive assurance on those items tested for compliance with the applicable laws and regulations, including the laws and regulations pertaining to financial reports and claims to federal agencies for advances and reimbursements, and a statement of negative assurance on those items not tested. It should also include material instances of noncompliance and all instances or indications of fraud, abuse, or illegal acts found during or in connection with the audit that may have an effect on the financial statements and on each major federal assistance program. The auditor should consider identifying in the report the individual amounts of questioned costs that resulted from material instances or indications of noncompliance, all instances and indications of fraud, abuse, or illegal acts, and for each federal assistance program, the total amount of questioned costs. Such identification would be made without regard to whether a condition giving rise to the questioned cost has been corrected or whether the recipient entity agrees with the finding or questioned cost. Any noncompliance found in transactions selected from federal assistance programs, other than major federal assistance programs, shall also be reported.

3.69 Although the GAO's Standards for Audit requires the auditor to report material instances of noncompliance encountered and the Single Audit Act requires reporting material instances of noncompliance with each major federal assistance program, considerable controversy surrounds the definition of materiality. Further, the Single Audit Act requires that any instance of noncompliance found in transactions relating to nonmajor federal assistance programs should also be reported. Accordingly, the independent auditor should consider reporting all exceptions and allow the grantor to determine whether further action is needed.

3.70 The Single Audit Act does not require the auditor's report on compliance to include a projection of questioned costs to the universe of federal financial assistance nor does it imply that the auditor expand the scope of audit to determine with greater precision the effect of any questioned costs.⁶ However, there may be instances where the existence of questioned costs could be the basis for the auditor, the grantor, or both, to question all costs charged to the federal programs. For example, in instances where eligibility requirements, matching, or cost-sharing conditions have not been met by the recipient, the entire amount received from federal grantors may be questioned. If such questions are subsequently sustained and such amounts are disallowed by the federal agency, the entire amount may have to be refunded to the federal agency. If the auditor concludes that the federal grantor agency will probably disallow the costs and such costs will likely be refunded to the grantor but the client does not record the liability for such costs, then the auditor should consider expressing a qualified or adverse opinion because of a departure from generally accepted accounting principles.

3.71 The designation by the auditor of a cost as questioned does not necessarily mean that the federal grantor will disallow the cost. In many instances the auditor will be unable to determine whether the federal grantor agency will, in fact, disallow the cost because the grantor has considerable discretion in this matter. The quality of questioned costs, rather than an aggregate amount, is one of the factors that a grantor agency will consider in deciding whether to disallow questioned costs. Federal grantor agencies also have an appeal and adjudication procedure for questioned costs. For single audits, the existence or disclosure of questioned costs should be viewed only as symptoms of conditions that federal grantors should investigate.

Client and Legal Representation

3.72 Generally accepted auditing standards require that the auditor obtain written representations from management. For single audits, this information should include not only management's representations concerning the identification of federal assistance but also representations concerning material

⁶For purposes of reporting on the financial statements taken as a whole, SAS No. 39, Audit Sampling, requires projection of error results of the sample to the items from which the sample was selected. This is appropriate in determining the possible effect of known errors on the financial statements. However, when applied to nonfinancial aspects of compliance with laws and regulations, the projection of questioned costs, for purposes of reporting such findings under the Single Audit Act, is not appropriate.

areas of noncompliance, such as using federal funds for political activity or paying wages less than those established for a specific locality.

3.73 Litigation, claims, and assessments of governmental units relating to disputes concerning completed contracts, terminated contracts, and past governmental audits or reviews should be made known to the auditor. Guidance in SAS No. 12, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments, would also apply to organizationwide audits. A lawyer's refusal to furnish the information requested in the inquiry letter, described in SAS No. 12, would constitute a limitation on the scope of the auditor's examination that would be sufficient to preclude the issuance of an unqualified opinion.

Reference to Appropriate Professional Bodies

3.74 The auditor should be aware that AICPA Ethics Interpretation 501-3, "Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits," states that when an auditor undertakes a governmental engagement and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, he is obliged to follow those standards or guidelines in addition to generally accepted auditing standards. Failure to do so is an act discreditable to the profession in violation of rule 501 of the AICPA Code of Professional Ethics unless he discloses in his report that he has not followed them and the reasons therefor.

Plan for Corrective Action

3.75 Among other requirements, the Single Audit Act requires the recipient entity to submit to appropriate federal officials either (a) a plan for corrective action to eliminate material noncompliance or weakness or (b) a statement describing the reasons that corrective action is not necessary. Normally, the cognizant agency will review, approve, and monitor progress on the plan. Such plan shall be consistent with the audit resolution standard promulgated by the Comptroller General as part of the standards for internal controls in the federal government.

AUDIT SAMPLING

3.76 SAS No. 39, Audit Sampling, discusses the factors to be considered in planning, designing, and evaluating audit samples. In addition, the AICPA Audit and Accounting Guide, Audit Sampling, provides detailed guidance to assist auditors in implementing SAS No. 39. Both documents discuss the use of audit sampling for tests of compliance with internal accounting controls and for substantive tests of details of account balances or classes of transactions.

3.77 Auditors conducting financial and compliance audits of state or local governmental units generally use audit sampling to perform three types of tests:

- o Substantive tests as part of the examination of the entity's financial statements in accordance with generally accepted auditing standards

- o Compliance tests of internal accounting control procedures that the auditor plans to rely on in restricting the scope of planned substantive tests
- o Compliance tests of the terms and conditions of federal assistance programs as part of the examination of the financial statements and for purposes of preparing the comments on compliance with laws and regulations

3.78 The guidance provided by SAS No. 39 and the Audit and Accounting Guide, Audit Sampling, discusses audit sampling only within the context of materiality as it relates to the examination of financial statements taken as a whole. In conducting an audit under the requirements of the Single Audit Act, for purposes of reporting on financial statements, the level of materiality relates to the financial statements taken as a whole.⁷ On the other hand, for purposes of reporting on compliance with laws and regulations, the level of materiality relates to the financial statements and to each major federal assistance program. An earlier section of this chapter, "Auditing Considerations," contains a discussion about applying the level of materiality to compliance matters.

3.79 The accounting records of many governmental entities include balances and transactions related to several federal financial assistance programs. If the auditor concludes that the objectives of testing for compliance with internal accounting controls are closely related to the objectives of testing for compliance with laws and regulations, then the auditor may decide to test the same accounting records simultaneously to meet both objectives. Thus, auditors may wish to plan their tests with both objectives in mind to avoid duplication of effort. For example, auditors may find it practical to follow one of two alternative approaches.

1. One approach is to select items or transactions from the records of each major federal assistance program in order to provide support for their comments on compliance under single audit requirements, and then, if necessary for purposes of the audit of the financial statements, to supplement those items or transactions with additional ones drawn from account balances and classes of transactions that are material to the financial statements, which may include transactions from nonmajor federal assistance programs.
2. The other approach is to select items or transactions from material account balances and classes of transactions in order to obtain sufficient evidence to express an opinion on the financial statements, and then, if necessary, to supplement those items or transactions tested with additional ones drawn from the records of major federal assistance programs to be reported on under single audit requirements.

3.80 The objectives of the selection and tests should be designed to provide a reasonable basis for both expressing an opinion on the financial statements and commenting on compliance or noncompliance with the terms and conditions of the major federal assistance programs.

⁷See note 8, page 22.

CHAPTER 4

FINANCIAL STATEMENTS

4.1 Various groups and individuals are interested in the financial statements of governmental units. For example:

Although governmental annual financial reports are useful to internal professional government managers, they are intended primarily to meet the information needs of governing boards and other parties external to a government. Users of governmental annual financial reports include, but are not limited to, taxpayers, service consumers, governing boards, oversight bodies, voters, investors and creditors, government employees, intergovernmental grantors, and participants in the annual operating budget/legal appropriation process.¹

4.2 Because of the widespread interest in their financial affairs, governmental units have generally published annual financial reports, including general purpose financial statements. As recognized in GASB Statement No. 1, the NCGA statements and interpretations provide guidance in preparing such annual financial reports. NCGA Statement 1, Governmental Accounting and Financial Reporting Principles, recommends that "every governmental unit should prepare and publish, as a matter of public record, a comprehensive annual financial report (CAFR) that encompasses all funds and account groups."² The CAFR is the governmental unit's official annual report. Exhibit 4-1 contains the general outline of a CAFR as recommended by the NCGA Statement 1.³

4.3 Traditionally, the federal government's informational needs and legal and regulatory requirements were satisfied by special reports, and its interest in the annual financial reporting process of a governmental unit was minimal. The single audit concept, however, has redirected the federal government's interest in that reporting process, and now annual or biennial audited financial statements are being prepared by state and local governmental units to comply with the requirements of the Single Audit Act.

4.4 Although the federal government's interest in the annual financial reporting process has been redirected, the effect on that process is mitigated because the Single Audit Act permits the governmental units to prepare the same annual financial statements that have traditionally been provided to the general public. However, a schedule of federal assistance, showing the total

¹ Municipal Finance Officers Association, Governmental Accounting, Auditing, and Financial Reporting (Chicago: Municipal Finance Officers Association, 1980), 23. This publication is an interpretation of accounting, auditing, and financial reporting practices.

² NCGA Statement 1, Governmental Accounting and Financial Reporting Principles (Chicago: Municipal Finance Officers Association, 1979), 19.

³ The auditor should refer to NCGA Statement 1 for a complete explanation of the CAFR.

expenditures for each major federal assistance program, should be included as a supplementary schedule. Accordingly, this chapter discusses governmental units' financial statements and the suggested format and content of the supplementary schedule.

FINANCIAL STATEMENTS

4.5 A financial report of a governmental unit may include a wide variety of financial information in addition to the basic financial statements. The types of information typically included are supplemental financial statements, schedules, and statistical data. The manner in which the auditor reports on the additional information depends on the scope of the auditor's examination, the nature of the additional information, and whether the information is included in a client-prepared document or included in an auditor-submitted document.

4.6 If the additional information consists of combining or individual fund financial statements and related schedules, the auditor should report on such financial statements and schedules as discussed below. The auditor's examination ordinarily either includes procedures related to individual fund and account group data or constitutes an examination of those financial statements. In an auditor-submitted document, the auditor should also report on any other data included in the financial report as discussed in SAS No. 29, Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents. If the auditor's report is included in a client-prepared financial report, the auditor should follow the guidance in SAS No. 8, Other Information in Documents Containing Audited Financial Statements, with respect to statistical or other data that the auditor has not examined.

4.7 By requiring audits to be conducted in accordance with the financial and compliance element of the GAO's Standards for Audit, the Single Audit Act requires the auditor to express an opinion as to whether the financial statements are fairly presented in accordance with generally accepted accounting principles. The Single Audit Act seems to encourage the preparation of financial statements in conformity with generally accepted accounting principles. However, if a governmental unit chooses to present its financial statements on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should follow the guidance provided in SAS No. 14, Special Reports.

4.8 If the governmental unit presents its financial statements in accordance with generally accepted accounting principles, the auditor should follow the reporting guidance provided in SOP 80-2,⁴ Accounting and Financial Reporting by Governmental Units, an amendment to the AICPA Industry Audit Guide, Audits of State and Local Governmental Units.

⁴In October 1984, the AICPA issued an exposure draft of a proposed revision of the Audit and Accounting Guide, Audits of State and Local Governmental Units. When it is published in final form, SOP 80-2 will be superseded.

4.9 NCGA Statement 1 provides a discussion and illustration of the general purpose financial statements and a discussion of the accounting principles underlying those statements and SOP 80-2 endorses NCGA Statement 1. Auditors should be thoroughly familiar with the provisions of NCGA Statement 1 and SOP 80-2.

4.10 In particular, auditors should be aware of the distinctions between the minimum financial statements required by generally accepted accounting principles and the CAFR. SOP 80-2 clearly endorses the NCGA Statement 1 provision that the minimum financial statements required by generally accepted accounting principles are the general purpose financial statements, also called the combined financial statements.⁵

4.11 Although the general purpose financial statements are the basic financial statements that should be presented to be in conformity with generally accepted accounting principles, SOP 80-2 recognizes the possibility of presenting, as additional information, individual fund and account group financial statements. NCGA Statement 1 encourages governmental units to include this additional information in their comprehensive annual financial report. Auditors should discuss this additional information with the governmental unit prior to commencing the audit in order to establish a clear understanding about the extent of audit work to be performed.

4.12 The type of report that the auditor can issue depends on the financial statements that a governmental unit presents and on the scope of the examination. Before beginning the audit, the auditor should discuss and obtain an understanding of the type of report desired by the governmental unit and document that understanding in the working papers.

4.13 NCGA Statement 1 and SOP 80-2 indicate that supplementary schedules may be presented. By requiring the auditor to report on whether the recipient entity has complied with laws and regulations that may have a material effect on each major federal assistance program, the Single Audit Act seems to require that information on major federal assistance programs be provided. This information is presented in a supplementary schedule of federal assistance within the annual report. The suggested format and content of this schedule are discussed in the remainder of this chapter.

SUPPLEMENTARY SCHEDULE OF FEDERAL ASSISTANCE

4.14 Although not required by the Single Audit Act, it may be desirable to present a supplementary schedule of federal assistance showing the total expenditures for each major federal assistance program. If presented, the schedule of federal assistance programs active during the year should identify all of the major federal assistance programs under which the governmental unit expended federal funds and show the total of the expenditures for each major federal assistance program. The supplementary schedule should list all the

⁵ See item II.2 in exhibit 4-1.

major federal assistance programs that are administered by the governmental unit and it should be covered by the independent auditor's report.

4.15 As illustrated in exhibit 4-2, the following information may be presented for each program:

- o Identification of each major program (normally by program or grant title, including the federal agency and federal ID number)
- o Total expenditures for each major federal assistance program

4.16 The financial information is obtained from the governmental unit's records and may be prepared on a different basis of accounting than the financial statements. In reporting on such information, the auditor should follow the reporting guidance provided in SAS No. 29, Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents or SAS No. 42, Reporting on Condensed Financial Statements and Selected Financial Data. If the information is prepared on a basis of accounting other than the basis on which the financial statements are presented, that basis should be disclosed.

4.17 If deemed appropriate, the schedule may also present other information for each program, such as the following:

- o Matching contributions
- o Amount of the program
- o Beginning and ending balances, such as unexpended amounts and/or accrued (deferred) amounts
- o Reconciliations to the financial statements

4.18 In addition to preparing financial statements and schedules, the recipient governmental unit should provide the auditor with the foregoing information as well as all relevant financial information related to the programs. The auditor should be aware that amounts presented in the supplementary schedule may not agree with the amounts reported in the financial statements because of the following:

- o Different bases of accounting may be used.
- o Programs may be reported in several fund types and individual funds.
- o Some programs may be reported as additions to equity rather than as results of operations.
- o Matching contributions may be reported in a fund type or fund different than the program itself.
- o Indirect costs may be reported in a fund type or fund that is different than the fund types or funds of the related programs.

4.19 Furthermore, the amounts presented in the supplementary schedule may not agree with the amounts reported in the federal financial reports, for various reasons, such as the following:

- o Different bases of accounting may be used.
- o Worksheet entries may be made to adjust amounts from the accounting records to arrive at amounts for federal financial reports.
- o Federal financial reports may not coincide with the government's fiscal year-end.
- o Federal financial reports may provide only cumulative data and not the activity of the current period.

4.20 Since federal agencies are the primary users of the supplementary schedule, financial data for nonmajor federal assistance programs and for state and other nonfederal assistance may be presented in total, as illustrated in exhibit 4-2. However, the supplementary schedule may present such information in a manner that is more useful to the state or other nonfederal users.

4.21 All financial statements, schedules, other data, and related auditor's reports may be included in one report, such as one bound document, so that it can be processed in the most efficient and effective manner. Under these circumstances, the financial statements and the auditor's report could be included in one section of the CAFR. The additional elements of the single audit report (schedule of federal assistance, auditor's report on internal controls, comments on compliance, schedule of findings and questioned costs, and corrective action plan) could be included as supplemental information in another section of the CAFR. Also, the entire single audit report may be issued separately in one document. Alternatively, the additional elements of the single audit report could be issued separately and incorporate, by reference, the general purpose financial statements. Exhibit 5-2 (in chapter 5) provides a suggested form of report when the auditor reports separately on the schedule of federal assistance and incorporates, by reference, the general purpose financial statements.

CONTENT OF A COMPREHENSIVE ANNUAL FINANCIAL REPORT

- I. Introductory section
- II. Financial section
 - A. Auditor's report*
 - B. General purpose financial statements (also called the combined financial statements)*
 - 1. Combined balance sheet (all fund types and account groups)
 - 2. Combined statement of revenues, expenditures, and changes in fund balances (all governmental fund types)
 - 3. Combined statement of revenues, expenditures, and changes in fund balances—budget and actual (general and special revenue fund types and similar government fund types for which annual budgets have been legally adopted)
 - 4. Combined statement of revenues, expenses, and changes in retained earnings (all proprietary fund types)
 - 5. Combined statement of changes in financial position (all proprietary fund types)
 - 6. Notes to the combined financial statements (trust fund operations may be reported in statements 2, 4, and 5 as appropriate, or separately)
 - C. Combining financial statements—by fund type where a governmental unit has more than one fund of a given fund type
 - D. Individual fund and account group statements to present budgetary comparisons for those individual funds included in a fund type column (other than the general fund) on the combined statement of revenues, expenditures, and changes in fund balances—budget and actual—general and special revenue fund types (and similar

* The auditor's report on the general purpose financial statements and the supplementary schedule of federal assistance, the auditor's report on the study and evaluation of internal control performed as a part of the financial and compliance audit, and the auditor's comments on compliance are the minimum reporting requirements of the Single Audit Act.

Source: NCGA Statement 1, Governmental Accounting and Financial Reporting Principles (Chicago: Municipal Finance Officers Association, March 1979).

Exhibit 4-1 (cont.)

governmental fund types for which annual budgets have been legally adopted) and to present the following information, to the extent considered necessary in the circumstances:

1. Prior year comparative data
2. More detail than is possible in the combined and combining financial statements
3. Budgetary comparisons beyond those discussed above
4. Demonstrate compliance with finance-related legal and contractual provisions
5. Information that is not otherwise provided but is considered necessary to ensure that the CAFR is fully informative

E. Schedules, if necessary, to—

1. Demonstrate compliance with finance-related legal and contractual provisions
2. Present information spread throughout the statements that can be brought together and shown in greater detail (for example, taxes receivable, including delinquent taxes; long-term debt; investments; and cash receipts, disbursements, and balances)
3. Present greater detail for information reported in the statements (for example, additional revenue sources detail and object of expenditure data by departments)

III. Statistical Tables

EXAMPLE GOVERNMENT
SUPPLEMENTARY SCHEDULE OF FEDERAL ASSISTANCE
FOR THE YEAR ENDED DECEMBER 31, 19X2

<u>Major Federal Assistance Programs</u>	<u>Federal Assistance ID Number</u>	<u>Amount of Expenditures</u>
<u>Agency/Program Grant Title</u>		
Department of Housing and Urban Development		
Community Development Block Grant	A-81-BC-10-567	\$ X,XXX,XXX
Community Development Block Grant	A-82-BC-10-567	<u>X,XXX,XXX</u>
		<u>X,XXX,XXX</u>
Department of Labor		
Comprehensive Employment and Training Act		
Title II	12-3-4567-89	XX,XXX
IIAB	12-3-4567-20	<u>XX,XXX</u>
		<u>XX,XXX</u>
Department of Health and Human Services		
Central Mental Health	01-A2345-67	XXX,XXX
North Mental Health	01-B2345-78	<u>XXX,XXX</u>
		<u>XXX,XXX</u>
Department of Agriculture		
Summer Feed-a-Kid	12-345-678	<u>XX,XXX</u>
Department of Justice		
Law Enforcement Assistance Administration	12-34-567	<u>XXX,XXX</u>
Environmental Protection Agency		
Facility Design	A-24589	- 0 -*
East River	A-35790	XXX,XXX
Facility Construction	A-35790	<u>XX,XXX,XXX</u>
		<u>XX,XXX,XXX</u>
Department of Transportation		
Federal Aviation Administration	76-25-A-035	XXX,XXX
Federal Aviation Administration	78-25-A-036	<u>X,XXX,XXX</u>
		<u>X,XXX,XXX</u>
Economic Development Administration	04-01-999-05	<u>XXX,XXX</u>
Revenue Sharing	11-1-111-111	<u>X,XXX,XXX</u>
Total Major Federal Assistance		<u>XX,XXX,XXX</u>
<u>Nonmajor Federal Assistance Programs</u>		<u>XXX,XXX</u>
<u>State and Other Nonfederal Assistance</u>		<u>X,XXX,XXX</u>
Total		\$ <u>XX,XXX,XXX</u>

Note: This schedule includes programs completed or terminated during the year being reported upon.

If the schedule is prepared on a basis of accounting other than GAAP, the basis should be disclosed.

* This item is intended to demonstrate that programs can be active without monies being expended during the audit period; such programs should be included in this schedule.

CHAPTER 5

AUDITOR'S REPORTS

5.1 To comply with the Single Audit Act, and the GAO's Standards for Audit, the auditor should issue the following three separate but interrelated reports:

1. A report on the financial statements of the recipient of federal assistance including the supplementary schedule of federal assistance
2. A report on the internal accounting controls of the recipient organization including internal controls used to manage federal financial assistance programs
3. Comments on the recipient organization's compliance with the terms and conditions of federal laws and regulations applicable to major and non-major federal assistance programs

5.2 These report components may be bound together and issued as one single audit report or may be issued separately. This chapter discusses and illustrates these report components.

AUDITOR'S REPORT ON FINANCIAL STATEMENTS

5.3 SOP No. 80-2,¹ Accounting and Financial Reporting by Governmental Units, provides guidance to the auditor in issuing an unqualified, as well as a qualified, opinion on a governmental unit's financial statements.

5.4 The GAO's Standards for Audit states the following:

A statement in the auditor's report that the examination was made in accordance with generally accepted government auditing standards for financial and compliance audits will be acceptable language to indicate that the audit was made in accordance with these standards.²

The AICPA requires certified public accountants to state that the examination was made in accordance with generally accepted auditing standards. Therefore, to satisfy the GAO requirement, the auditors should refer to the GAO's Standards for Audit only in the report on internal accounting control and the comments on compliance.

5.5 As discussed in chapter 4, the independent auditor will also report on a supplementary schedule of federal assistance, which is considered to be additional data. The reporting requirements for additional data are also discussed in SOP No. 80-2 as well as SAS No. 29, Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents.

¹ See note 8, page 22.

² GAO's Standards for Audit, 28.

Unqualified Opinion

5.6 Exhibit 5-1 illustrates a report that covers both the financial statements and the supplementary schedule of federal assistance. The report illustrated in exhibit 5-2 covers only the supplementary schedule of federal assistance.

Qualified Opinion

5.7 SAS No. 2, Reports on Audited Financial Statements, states that a qualified opinion is expressed "when a lack of sufficient competent evidential matter or restrictions on the scope of the auditor's examination have led him to conclude that he cannot express an unqualified opinion, or when the auditor believes, on the basis of his examination that ... there are significant uncertainties affecting the financial statements."

5.8 The following are two situations that may cause the auditor to issue a qualified opinion:

- o A substantial amount of grant revenues have been given to subrecipients. Control over the recipient's payments to subrecipients may be insufficient to allow the auditor to determine whether there is a significant liability regarding noncompliance with the terms of the grant.
- o There may be significant uncertainties concerning the ultimate disallowance of questioned costs by federal grantor agencies. The recipient government could be required to return portions of federal grant money. Hence, if there are material uncertainties, the outcome of which is not susceptible of reasonable estimation, the auditor should consider whether to express an unqualified or qualified opinion.

5.9 Illustrations of the form of the opinion to be used in reporting such qualifications are presented in exhibits 5-3 and 5-4.

AUDITOR'S REPORT ON INTERNAL ACCOUNTING CONTROL

5.10 Both generally accepted auditing standards and the GAO's Standards for Audit require a proper study and evaluation of the system of internal accounting control as a basis for determining the extent to which auditing procedures are to be restricted.

5.11 The Single Audit Act also requires that the auditor determine and report whether the recipient has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with laws and regulations. This requirement "does not require the auditor to render an opinion on the recipient's internal control systems over its federal financial assistance programs. However, the auditor's report on the study and evaluation of the systems should identify, at a minimum, the controls in place and studied; the material weaknesses found; and the controls

not relied on and the reasons therefor."³ The number of transactions selected and the amount of testing is determined by the auditor's professional judgment.

5.12 The Single Audit Act and the GAO's Standards for Audit contain reporting requirements relating to internal control that go beyond generally accepted auditing standards. Page 29 of the GAO's Standards for Audit states the following:

The auditors shall report on their study and evaluation of internal accounting controls made as part of the financial and compliance audit. They shall identify as a minimum: (1) the entity's significant internal accounting controls, (2) the controls identified that were evaluated, (3) the controls identified that were not evaluated (the auditor may satisfy this requirement by identifying any significant classes of transactions and related assets not included in the study and evaluation), and (4) the material weaknesses identified as a result of the evaluation.

5.13 The GAO's Standards for Audit specifically states that no additional audit effort, other than that required as a part of a normal financial and compliance audit, is necessary. To meet these requirements, the sample report provided in paragraph 49 of SAS No. 30 (when a study and evaluation made as part of the audit is not sufficient for expressing an opinion on the system taken as a whole) should be modified, as illustrated by exhibit 5-5, to identify the entity's significant accounting controls, those controls that have been evaluated and those that have not, and why. In addition, since the Single Audit Act requires the auditor to determine and report whether the recipient has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with laws and regulations, the internal control report should also identify the controls in place and studied, the material weaknesses found, and the controls not relied on and the reasons therefor.

Identification of Internal Controls

5.14 Depending on the circumstances, classifications or categories of internal controls identified as a part of an organization's system may include transaction cycles, financial statement captions, accounting system applications, and major federal assistance programs. Exhibit 5-5 provides examples of ways in which controls might be classified.

Comments on Material Control Weaknesses

5.15 The Single Audit Act requires material weaknesses in and noncompliance with the system of internal control to be reported. Paragraph 3 of SAS No. 20, Required Communication of Material Weaknesses in Internal Accounting Control, notes that the auditor may become aware of material weaknesses through the preliminary review of the system or by performing substantive tests of

³Report of Committee on Government Operations, House of Representatives, April 25, 1984, Report 98-708, 10.

account balances. Material weaknesses coming to the auditor's attention during the audit should be reported even though the material weaknesses relate to a category of controls excluded from the study and evaluation.

AUDITOR'S COMMENTS ON COMPLIANCE

5.16 The auditor's comments on compliance are submitted in a report prepared specifically for the federal agencies. These comments are a narrative summary of the scope of work performed with regard to testing the recipient's compliance with terms and conditions of federal assistance programs and related laws and regulations. The comments should contain a statement of positive assurance on those items of compliance tested and should provide negative assurance regarding the auditor's awareness of any instances of noncompliance for those transactions and activities not tested.

5.17 Positive assurance consists of a statement by the auditors that the tested items were in compliance with applicable laws and regulations. Negative assurance is a statement that nothing came to the auditors' attention as a result of specified procedures that caused them to believe the untested items were not in compliance with applicable laws and regulations.

5.18 Material instances of noncompliance should be reported. Minor procedural noncompliance that is not illegal need not be disclosed.

5.19 Although the GAO's Standards for Audit requires the auditor to report material instances of noncompliance encountered and the Single Audit Act requires reporting material instances of noncompliance with each major federal assistance program, considerable controversy surrounds the definition of materiality. Further, the Single Audit Act requires that any instance of noncompliance found in transactions relating to nonmajor federal assistance programs should also be reported. Accordingly, the independent auditor should consider reporting all exceptions and allow the grantor to determine whether further action is needed. The auditor's reporting is not based on whether the recipient organization agrees with the comments or whether the financial statements have been adjusted to reflect the effect of such noncompliance. If a compliance violation is determined to exist, the auditor should not eliminate the comment on the compliance violation just because the recipient government decides to adjust the financial statements or accept other than an unqualified opinion.

5.20 Exhibit 5-6 illustrates the auditor's comments on compliance. Some important aspects of these comments are discussed below.

Scope. The scope paragraph of the auditor's compliance comments is limited to the financial and compliance elements. This limitation is designed to clearly indicate that expanded scope audits of economy, efficiency, and program results, as contemplated by the GAO's Standards for Audit, is not a required part of a single audit performed by nongovernment auditors.

No opinion required. The Single Audit Act does not require the auditor to express an opinion on compliance. Rather, the GAO's

Standards for Audit requires the auditor to express positive assurance on items tested and negative assurance on the balance of the transactions not tested.

Findings of noncompliance. Findings of noncompliance are generally listed in a schedule that indicates the dollar amount of costs, if any, of federal programs spent in a manner that did not comply with the terms and conditions of the assistance agreements and regulations. In reporting noncompliance, auditors should place their findings in proper perspective. The extent of noncompliance should be related to the number of cases examined and materiality is generally determined on the basis of the relationship of the amount questioned to the federal assistance program in order to give the reader a basis for judging the prevalence of noncompliance. When noncompliance is reported, the auditor may wish to list the number and dollar amounts of items tested, the total universe, and the number and dollar amounts of noncompliance by program. The use of a table may be appropriate to summarize extensive findings.⁴ (Exhibit 5-7 illustrates the reporting of instances of noncompliance.)

Restrictive use paragraph. The auditor's letter of comments indicates that it should be used only for purposes of satisfying the single audit requirement. The letter of comments is not considered to be a general purpose report and therefore its use should be restricted.

Other compliance requirements. If compliance testing includes federal assistance programs that are not covered by the Compliance Supplement, the scope paragraph illustrated in the compliance comments in exhibit 5-6 should be expanded to indicate the source of the compliance requirements, such as laws, regulations, agreements, or contracts, used for testing those programs.

⁴In presenting the findings the auditor should follow chapter VII, sections D and E, of the GAO's Standards for Audit.

AUDITOR'S REPORT
ON GENERAL PURPOSE FINANCIAL STATEMENTS
AND SUPPLEMENTARY SCHEDULE OF FEDERAL ASSISTANCE
UNQUALIFIED OPINION

September 21, 19XX

To the Honorable Members of the City Council, City of X:

We have examined the general purpose financial statements of the City of X as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the general purpose financial statements referred to above present fairly the financial position of each of the fund types and account groups of the City of X, at June 30, 19XX, and the results of operations of such fund types and the changes in financial position of the proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination was made for the purpose of forming an opinion on the general purpose financial statements. The information included in the supplementary schedule of federal assistance* listed in the table of contents is presented for purposes of additional analysis and is not a required part of the general purpose financial statements of the City of X. Such information has been subjected to the auditing procedures applied in the examination of the general purpose financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements of each of the fund types and account groups included in the general purpose financial statements taken as a whole.

Note: The exposure draft of the proposed audit and accounting guide, Audits of State and Local Governmental Units, specifies that the auditor's opinion on the general purpose financial statements is an opinion on each of the fund types and account groups. If the financial statements are for a component unit other than the oversight unit, the scope paragraph should refer to "the financial statements of XYZ, a component unit of the City of X" and the opinion paragraph should refer to "the component unit financial statements."

* See presentation of exhibit 4-2.

AUDITOR'S REPORT
ON SUPPLEMENTARY SCHEDULE OF FEDERAL ASSISTANCE
NOT PART OF REPORT ON GENERAL PURPOSE FINANCIAL STATEMENTS
UNQUALIFIED OPINION

September 21, 19XX

To the Honorable Members of the City Council, City of X:

We have examined the general purpose financial statements of the City of X as of and for the year ended June 30, 19XX, and have issued our report thereon dated September 21, 19XX. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Our examination was made for the purpose of forming an opinion on the general purpose financial statements. The information included in the supplementary schedule of federal assistance* listed in the table of contents is presented for purposes of additional analysis and is not a required part of the general purpose financial statements of the City of X. Such information has been subjected to the auditing procedures applied in the examination of the general purpose financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements of each of the fund types and account groups included in the general purpose financial statements taken as a whole.

Note: The exposure draft of the proposed audit and accounting guide, Audits of State and Local Governmental Units, specifies that the auditor's opinion on the general purpose financial statements is an opinion on each of the fund types and account groups. If the financial statements are for a component unit other than the oversight unit, the scope paragraph should refer to "the financial statements of XYZ, a component unit of the City of X" and the opinion paragraph should refer to "the component unit financial statements."

* See presentation of exhibit 4-2.

AUDITOR'S REPORT
ON GENERAL PURPOSE FINANCIAL STATEMENTS
AND SUPPLEMENTARY SCHEDULE OF FEDERAL ASSISTANCE
QUALIFIED OPINION - SCOPE LIMITATION

September 21, 19XX

To the Honorable Members of the City Council, City of X:

We have examined the general purpose financial statements of the City of X as of and for the year ended June 30, 19XX, as listed in the table of contents. Except as explained in the following paragraph, our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described more fully in note X to the financial statements, approximately 45 percent of the total expenditures made from the special revenue funds are payments to subrecipients to administer programs under the terms and conditions of federal financial assistance made to the city. The terms and conditions of such assistance require audits of the financial statements of subrecipients to be performed. However, such audits were not performed. Due to the nature of the city's internal accounting control systems, we were unable to perform other auditing procedures to satisfy ourselves concerning compliance of subrecipients with the terms and conditions of the federal financial assistance.

In our opinion, except for the effects on the financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves concerning compliance of subrecipients with the terms and conditions of the federal financial assistance referred to above, the general purpose financial statements referred to above present fairly the financial position of each of the fund types and account groups of the City of X, at June 30, 19XX, and the results of operations of such fund types and the changes in financial position of the proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Note: The exposure draft of the proposed audit and accounting guide, Audits of State and Local Governmental Units, specifies that the auditor's opinion on the general purpose financial statements is an opinion on each of the fund types and account groups. If the financial statements are for a component unit other than the oversight unit, the scope paragraph should refer to "the financial statements of XYZ, a component unit of the City of X" and the opinion paragraph should refer to "the component unit financial statements."

Exhibit 5-3 (cont.)

Our examination was made for the purpose of forming an opinion on the general purpose financial statements. The information included in the supplementary schedule of federal assistance* listed in the table of contents is presented for purposes of additional analysis and is not a required part of the general purpose financial statements of the City of X. Such information has been subjected to the auditing procedures applied in the examination of the general purpose financial statements and, in our opinion, except for the effects on the supplementary schedule of federal assistance of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves concerning compliance of subrecipients with the terms and conditions of federal assistance, as explained above, is fairly stated in all material respects in relation to the financial statements of each of the fund types and account groups included in the general purpose financial statements taken as a whole.

* See presentation of exhibit 4-2.

AUDITOR'S REPORT
ON GENERAL PURPOSE FINANCIAL STATEMENTS
AND SUPPLEMENTARY SCHEDULE OF FEDERAL ASSISTANCE
QUALIFIED OPINION - UNCERTAINTY

September 21, 19XX

To the Honorable Members of the City Council, City of X:

We have examined the general purpose financial statements of the City of X as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in note X to the general purpose financial statements, certain expenditures, which were incurred by the City of X and reimbursed under federal assistance, have been questioned. The ultimate resolution of the questioned costs cannot presently be determined, and no provision for any liability has been made in the general purpose financial statements.

In our opinion, subject to the effects on the general purpose financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty (or resolution of questioned costs) referred to in the preceding paragraph been known, the general purpose financial statements referred to above present fairly the financial position of each of the fund types and account groups of the City of X, at June 30, 19XX, and the results of operations of such fund types and the changes in financial position of the proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination was made for the purpose of forming an opinion on the general purpose financial statements. The information included in the supplementary schedule of federal assistance* listed in the table of contents is presented for purposes of additional analysis and is not a required part of the general purpose financial statements of the City of X. Such information has been subjected to the auditing procedures applied in the examination of the general

Note: The exposure draft of the proposed audit and accounting guide, Audits of State and Local Governmental Units, specifies that the auditor's opinion on the general purpose financial statements is an opinion on each of the fund types and account groups. If the financial statements are for a component unit other than the oversight unit, the scope paragraph should refer to "the financial statements of XYZ, a component unit of the City of X" and the opinion paragraph should refer to "the component unit financial statements."

* See presentation of exhibit 4-2.

Exhibit 5-4 (cont.)

purpose financial statements and, in our opinion, subject to the effects on the supplementary schedule of federal assistance of such adjustments, if any, as might have been required had the outcome of the uncertainty (or resolution of questioned costs) referred to above been known, is fairly stated in all material respects in relation to the financial statements of each of the fund types and account groups included in the general purpose financial statements taken as a whole.

AUDITOR'S REPORT
ON INTERNAL ACCOUNTING CONTROL
BASED SOLELY ON A STUDY AND EVALUATION MADE
AS PART OF A SINGLE AUDIT

September 21, 19XX

To the Honorable Members of the City Council, City of X:

We have examined the general purpose financial statements of the City of X for the year ended June 30, 19XX, and have issued our report thereon dated September 21, 19XX. As part of our examination, we made a study and evaluation of the system of internal accounting control of the City of X to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards, the standards for financial and compliance audits contained in the U.S. General Accounting Office Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, and the Single Audit Act of 1984 (Pub. L. No. 98-502). For the purpose of this report, we have classified the significant internal accounting controls in the following categories [identify control categories]:¹

Our study included all of the control categories listed above except that we did not evaluate the accounting controls over [identify any category not

Note: The Single Audit Act requires that a single audit determine and report whether the government, department, agency, or establishment has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. This illustrative report satisfies that requirement.

The Interpretation of SAS No. 30 provides further guidance and is included as Appendix C of this audit guide.

¹ Given below are examples of four different ways in which controls might be classified. The auditor should modify these examples or use other classifications as appropriate for the particular circumstances on which he is reporting.

1. Cycles of the Entity's Activity

- o Treasury or financing
- o Revenue/receipts
- o Purchases/disbursements
- o External financial reporting

2. Financial Statement Captions

- o Cash and cash equivalents
- o Receivables
- o Inventory
- o Property and equipment
- o Payables and accrued liabilities
- o Debt
- o Fund balance

Footnote continued

evaluated] because [state reasons for excluding any category from the evaluation]. The purpose of our study and evaluation was to determine the nature, timing, and extent of performing the auditing procedures necessary for expressing an opinion on the city's general purpose financial statements.² Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting control taken as a whole or on any of the categories of controls identified above.

The management of the City of X is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, the City is managing its federal financial assistance programs in compliance with laws and regulations, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of the City of X taken as a whole or on any of the categories of controls identified in the first paragraph. However, our study and evaluation disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would

Footnote continued from page 70

3. Accounting Applications

- o Billings
- o Receivables
- o Cash receipts
- o Purchasing and receiving
- o Accounts payable
- o Cash disbursements
- o Payroll
- o Inventory control
- o Property and equipment
- o General ledger

4. Major Federal Assistance Programs

- o Eligibility
- o Types of services
- o Matching level of effort
- o Reporting

²See note, page 68.

Exhibit 5-5 (cont.)

be material in relation to the financial statements of the City of X may occur and not be detected within a timely period.³ [A description of the material weaknesses that have come to the auditor's attention would follow.]⁴

These conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in our examination of the 19XX general purpose financial statements, and this report does not affect our report on the general purpose financial statements dated September 21, 19XX.

This report is intended solely for the use of management and [name of regulatory agency or other third party] and should not be used for any other purpose.⁵

³If the study and evaluation discloses no material weaknesses, this sentence would state, "However, our study and evaluation disclosed no condition that we believe to be a material weakness," and the following paragraph of this report, which begins with "These conditions . . . ," would be omitted.

⁴All material weaknesses that have come to the auditor's attention during the audit would be described, whether or not they relate to a category of controls that was excluded from the study and evaluation. Paragraph 3 of SAS No. 20, Required Communication of Material Weaknesses in Internal Accounting Control, notes that the auditor may become aware of material weaknesses through the preliminary review of the system or by performing substantive tests of account balances.

⁵Footnote 7 of SAS No. 30, Reporting on Internal Accounting Control, states that this form of reporting is appropriate even though by law or regulation the accountant's report may be made a matter of public record.

AUDITOR'S COMMENTS ON COMPLIANCE FOR SINGLE AUDITS

September 21, 19XX

To the Honorable Members of the City Council, City of X:

We have examined the general purpose financial statements of the City of X, for the year ended June 30, 19XX, and have issued our report thereon dated September 21, 19XX. Our examination was made in accordance with generally accepted auditing standards; the provisions of Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, promulgated by the U.S. Comptroller General, as they pertain to financial and compliance audits; the Single Audit Act of 1984 (Pub. L. No. 98-502); the provisions of the Office of Management and Budget's Compliance Supplement for Single Audits of Grants to State and Local Governments¹ (the Compliance Supplement), and accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In connection with the examination referred to above, a representative number of transactions from each major federal assistance program were selected to determine if federal funds are being expended in accordance with the terms of applicable agreements and those provisions of federal law or regulations that could have a material effect on the financial statements or on each major federal assistance program tested. The results of our tests indicate that for the items tested, the City of X complied with the material terms and conditions of the federal assistance agreements, except as described in the schedule of findings and questioned costs.² Further, for the items not tested, based on our examination and the procedures referred to above, nothing came to our attention to indicate that the City of X had not complied with the significant compliance terms and conditions of the programs referred to above beyond the findings and questioned costs noted above.

This report is intended solely for the use of the City of X, the cognizant audit agency, and other federal audit agencies. This restriction is not intended to limit the distribution of this report, which, upon acceptance by the City of X, is a matter of public record.

¹If the auditor, using professional judgment, decides not to use the Compliance Supplement, he would not refer to it in the report. Instead, reference would be made to the appropriate statutes, regulations, or agreements governing the assistance programs.

²For illustrative purposes, this schedule has been shown as exhibit 5-7 to this guide.

CITY OF X
 SCHEDULE OF FINDINGS AND QUESTIONED COSTS
 For the Year Ended June 30, 19XX

Program	Finding	Questioned Costs
<u>Community Development Block Grant</u>		
1. Grant No. B-78-MC-14-00009	Of twenty-five vehicles examined, one vehicle equipped with special photographic equipment was purchased and used in sewer inspections. The vehicle was used to perform repair and engineering work in the Bancroft subdivision (which is an approved project). However, it was also used on a citywide basis. Furthermore, the Department of Housing and Urban Development (HUD) approval was not obtained prior to its acquisition.	\$ 28,765
2. Grant No. B-80-MC-14-0009	Of thirty-six projects examined, monies were expended on two projects, Stanley Park and Syn Way, which were not approved by HUD because appropriate environmental review procedures were not followed. The city intends to repay HUD for these costs.	49,843 \$ 78,608
<u>Work Incentive Program</u>		
1. Grant No. 18-9-0468-47	Of thirty employee files examined, wages for two participants were paid at an hourly rate in excess of that allowable by the grant.	\$ 132
2. Grant No. 06-9029-XX	The city has no general indirect cost allocation plan approved under the provisions of OMB Circular A-87. However, the city had entered into a specific agreement with the Department of Health and Human Services (HHS) which provided that certain personnel costs incurred in support of work incentive programs in departments other than the city's Department of Human Resources could be charged to the grant, provided such charges were based on actual time spent in support of the program. This agreement, which was dated October 19, 19X0, expired on June 30, 19XX. In the year under audit, the city charged a total of \$203,486 to grant 06-9029-XX under the terms of the agreement. Of the \$203,486, \$36,658 was incurred prior to July 1, 19XX. The remaining \$166,828 was incurred subsequent to July 1, 19XX, after the agreement had expired. Therefore, we consider \$166,828 as questioned costs.	\$ 166,828 \$ 166,960

<u>Program</u>	<u>Finding</u>	<u>Questioned Costs</u>
<u>Urban Mass Transit Administration</u>		
1. Grant No. 872-8190-41	This program allows contributions to a self-insurance escrow account as eligible expenses subject to certain conditions. One of these conditions is that the amounts represented as eligible expenses must reflect actual cash deposits to the account. A brief summary of the self-insurance activity follows.	\$ <u>525,387</u>
	<u>19XX</u>	
	Expense recorded	\$4,255,612
	Cash deposited	<u>3,730,225</u>
	Total questioned costs	\$ <u>525,387</u>

Federal Financial Reports

Quarterly Financial Status Reports had not been filed on a timely basis as required by Attachment H of Circular A-102.

Quarterly financial status reports for certain grant projects were filed in excess of thirty days after the end of each quarter. Following is a summary of the reports noted to be in violation of this requirement.

Year Ended December 31, 19XX

<u>Period to Which Report Is Related</u>	<u>Date of the City's Cover Letter Accompanying Report</u>
First Quarter	November 20, 19XX
Second Quarter	February 11, 19X1
Third and Fourth Quarters	August 7, 19X1

CHAPTER 6

ADDITIONAL AUDITS OF FEDERAL FINANCIAL ASSISTANCE PROGRAMS

6.1 The preceding chapters discussed audit considerations and requirements that are necessary to comply with the requirements of the Single Audit Act. This chapter discusses audits of federal assistance programs conducted on other than an organizationwide basis.

NATURE OF ADDITIONAL AUDITS

6.2 The provisions of the Single Audit Act do not limit the authority of a federal agency to conduct or contract for additional audits of a recipient organization. However, the Single Audit Act provides that any additional audit work should be based upon the work already performed.

6.3 Auditors may be engaged to perform tests of financial transactions, compliance activities, or both, in addition to those performed as part of a single audit. For example, a federal agency may engage an independent auditor to conduct an audit of a specific federal program or award, to test federal financial reports, to test adherence to the compliance features of the OMB's Compliance Supplement, or to determine consistency with the cost principles set forth in OMB Circular A-87.

6.4 Other reasons that may cause a federal agency to conduct or contract for additional audit work include—

- o Significant weaknesses in the recipient's system of internal accounting control disclosed by the independent auditor's comments.
- o The grantor decides to determine the full extent of questioned costs upon disclosures of findings and questioned costs indicating system weaknesses.
- o Disclosure of federal program problems, such as weaknesses in internal accounting control that are likely to be occurring at other recipient locations.
- o Additional audit coverage is required by the grantor for a specific recipient or a specific grant award.
- o Additional testing of noncompliance with certain program provisions is required in order to quantify the effect of such noncompliance on the financial statements.
- o Compliance with the requirements of financial reporting provisions of federal regulations requires that reports be prepared in accordance with a basis of accounting other than generally accepted accounting principles.

DETERMINATION OF THE APPROPRIATE FORM OF REPORTING

6.5 The additional audit requirements may encompass financial statements of one or more programs or selected financial information, such as specified elements, accounts, or items of a financial statement of a federally assisted program.

6.6 The financial statements or information may be presented in conformity with generally accepted accounting principles or on a comprehensive basis of accounting other than generally accepted accounting principles, such as the cash basis or a basis of accounting prescribed by a regulatory agency. Among the factors an independent auditor should consider in determining the appropriate form of report are whether the statements have been prepared in conformity with generally accepted accounting principles and whether they constitute complete financial statements or a specified element, account, or item of a financial statement.

6.7 If the financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the independent auditor should follow the guidance in paragraphs 2 through 8 of SAS No. 14, Special Reports. Paragraphs 9 through 14 of SAS No. 14, address reports on specified elements, accounts, or items of a financial statement when the information or the statements do not constitute complete financial statements.

6.8 If an auditor accepts an engagement involving one or more specified elements, accounts, or items of a financial statement and the scope of the engagement is limited to applying agreed-upon procedures that are not sufficient to enable the auditor to express an opinion on the specified elements, accounts, or items, the auditor should follow the guidance provided in SAS No. 35, Special Reports--Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement.

6.9 If the independent auditor is engaged to report on other financial information, such as a supplementary schedule, as discussed in chapter 4, in addition to the basic financial statements, the guidance in SAS No. 29, Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents, should be followed.

6.10 When an entity has several awards or programs, each with separate reporting requirements that may not be met by a report on the entity's basic financial statements, the auditor should consider issuing reports on the individual awards or programs if the scope of the audit is sufficient to enable him to express an opinion.

6.11 Two illustrative special reports follow. However, the form of each report will vary depending on the circumstances and requirements of the individual engagements.

AUDITOR'S REPORT
ON FEDERAL FINANCIAL REPORTS
PREPARED ON A BASIS PRESCRIBED BY A GRANTOR AGENCY

September 30, 19X2

To [grantor]:

We have examined the federal financial status report, the federal cash transactions report, and the request for advance or reimbursement report of [grant] awarded to [recipient] for the period July 1, 19X1, through June 30, 19X2. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in note X, the [recipient's] policy is to prepare its federal financial reports on the basis of accounting practices prescribed by [grantor] reporting requirements and in conformity with its regulations. These practices differ in some respects from generally accepted accounting principles. Accordingly, the accompanying federal financial reports are not intended to present financial position and results of operations in conformity with generally accepted accounting principles. This report is intended solely for filing with the [grantor] and should not be used for any other purpose.

In our opinion, the federal financial reports referred to above present fairly the financial status, the cash transactions, and the advances and reimbursements of [recipient] for the period July 1, 19X1, through June 30, 19X2, on the basis of accounting described in note X, which basis has been applied in a manner consistent with that of the preceding year.

AUDITOR'S REPORT
ON COMPLIANCE WITH ASPECTS OF A GRANT AGREEMENT
OF A RECIPIENT ORGANIZATION

September 7, 19X2

To [grantor]:

At your request, we have performed the agreed-upon procedures enumerated below with respect to [grant] awarded to [recipient] for the period July 1, 19X1, through June 30, 19X2, set forth in the accompanying schedules. Our review was made solely to assist you in evaluating the allowability of certain expenditures, and our report is not to be used for any other purpose. The procedures we performed are summarized as follows:

1. We examined documentation for all administrative travel expenditures charged to the grant, including travel claims, motel invoices, and other evidence of travel.
2. We tested the eligibility of 50 percent of the participants in the program, selecting the participants at random.
3. We examined documentation for all supplies purchased during June 19X2 and reviewed the propriety of such purchases in accordance with the "necessary and reasonable" criteria of OMB Circular A-87.

Except as set forth in schedule B, we found the expenditures of [grant] listed in schedule A claimed by [recipient] to be allowable under the terms of the [grant] and its applicable regulations. Schedule A lists the items tested, and schedule B lists the items we believe to be unallowable and the amount of such charges to the grant.

Because the above-mentioned procedures do not constitute an examination made in accordance with generally accepted auditing standards, we do not express an opinion on the overall allowability of the expenditures claimed by the [recipient] under the [grant] for the period July 1, 19X1, through June 30, 19X2. In connection with the procedures referred to above, except as set forth in schedule B, no matters came to our attention that caused us to believe that other expenditures might not be allowable. Had we performed additional procedures or had we made an examination of the financial and program records of the [grant] in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you. This report relates only to evaluating the allowability of certain expenditures specified above and does not extend to any financial statements of the [recipient] taken as a whole.

APPENDIX A

GLOSSARY

Awards. See Federal Financial Assistance.

Cognizant Agency. A federal agency that is assigned by the Director of the OMB with the responsibility for implementing the requirements of the Single Audit Act with respect to a particular state or local government.

Compliance. A determination of whether (1) there is compliance with laws and regulations that could materially affect the entity's financial position and statements and each major federal assistance program, (2) there is compliance with laws and regulations that could significantly affect the acquisition, management, and utilization of the entity's resources, and (3) programs are being carried out in conformity with laws and regulations.*

Federal Financial Assistance. Assistance provided by a federal agency in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations, but does not include direct federal cash assistance to individuals.

Financial and Compliance Audits. Audits that determine (1) whether the financial statements of an audited entity present fairly the financial position and the results of financial operations in conformity with generally accepted accounting principles and (2) whether the entity has complied with laws and regulations that may have a material effect upon the financial statements.

Findings. Conclusions based on the sum of the information about an organization, program, activity, function, condition, or other matter that was analyzed or evaluated because it was considered of interest, concern, or use to the entity, the grantor, the cognizant agency, or others.

Grant. See Federal Financial Assistance.

Indian Tribe. Any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

Local Government. Any unit of local government within a state, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, interstate district, council of governments, and any other instrumentality of local government.

* Economy and efficiency and program results elements of audits are not required by the Single Audit Act.

Major Federal Assistance Program. Any program for which total expenditures of Federal financial assistance by the state or local governments during the applicable year exceed—

- o \$20 million in the case of a state or local government for which such total expenditures for all programs exceed \$7 billion.
- o \$19 million in the case of a state or local government for which such total expenditures for all programs exceed \$6 billion but are less than or equal to \$7 billion.
- o \$16 million in the case of a state or local government for which such total expenditures for all programs exceed \$5 billion but are less than or equal to \$6 billion.
- o \$13 million in the case of a state or local government for which such total expenditures for all programs exceed \$4 billion but are less than or equal to \$5 billion.
- o \$10 million in the case of a state or local government for which such total expenditures for all programs exceed \$3 billion but are less than or equal to \$4 billion.
- o \$7 million in the case of a state or local government for which such total expenditures for all programs exceed \$2 billion but are less than or equal to \$3 billion.
- o \$4 million in the case of a state or local government for which such total expenditures for all programs exceed \$1 billion but are less than or equal to \$2 billion.
- o \$3 million in the case of a state or local government for which such total expenditures for all programs exceed \$100 million but are less than or equal to \$1 billion.
- o The larger of \$300 thousand or 3 percent of such total expenditures for all programs, in the case of a state or local government for which such total expenditures for all programs exceed \$100 thousand but are less than or equal to \$100 million.

Negative Assurance. A statement by the auditor that for the transactions not tested, nothing came to the auditor's attention, as a result of audit procedures applied to tested transactions, to indicate that the audited entity had not complied with the terms and conditions of the federal awards, contracts, or agreements.

Positive Assurance. A statement by the auditor that for the transactions tested, the audited entity complied with the material terms and conditions of the federal awards, contracts, or agreements, and the tested federal financial reports present the underlying financial data of the awards.

Questioned Costs. Those costs, which, in the auditor's opinion, may not comply with or may not be consistent with the grantor's requirements covering its

contracts and awards or governmentwide policies (such as an OMB circular) governing the allocability, allowability, or reasonableness of costs charged to federally assisted programs.

State. Any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multistate, regional, or interstate entity that has governmental functions, and any Indian tribe.

Subrecipient. Any person or government department, agency, or establishment that receives federal financial assistance through a state or local government, but does not include an individual that receives such assistance.

APPENDIX B

OMB CIRCULARS THAT ADDRESS MANAGEMENT OF FEDERAL ASSISTANCE PROGRAMS APPLICABLE TO STATE AND LOCAL GOVERNMENTS

B.1 The U.S. Office of Management and Budget (OMB), in consultation with federal grant-making agencies, the General Accounting Office (GAO), and representatives of recipient governments, has developed a series of financial circulars that establish a system of guidance to be observed by all federal executive branch agencies in imposing financial and other administrative requirements on recipients of federal assistance. Two of these circulars, A-87 and A-102, applicable to state and local governments, are summarized below.

OMB CIRCULAR A-87 (formerly FMC 74-4) COST PRINCIPLES APPLICABLE TO GRANTS AND CONTRACTS

WHAT IS CIRCULAR A-87?

B.2 Circular A-87 provides uniform rules for determining costs applicable to grants and contracts with state and local governments. It defines allowable costs and sets forth the procedures to recover them. The basic intent underlying the circular is that federally assisted programs should bear their fair share of costs. The circular also provides that one federal agency¹ will negotiate grantees' indirect costs on behalf of all other federal agencies.

Allowable Costs

B.3 Generally, costs must be necessary, reasonable, and directly related to the grant. In addition, they must be legal, proper, and consistent with the policies that govern the recipient's own expenditures. Any credits, such as purchase discounts, price adjustments, and federal funds available from other sources, must be deducted from total costs.

Composition of Cost

B.4 Costs applicable to a grant program may be direct or indirect. There are no strict guidelines for classifying costs as direct or indirect. In most cases, the accounting system used by the recipient will specify which types of costs are direct and which are indirect. The important point is that recipients treat costs consistently for all grant programs.

B.5 Direct costs should be specifically identifiable to the grant. Typical examples are employee compensation, materials, equipment, and services furnished specifically for the grant by others.

B.6 Indirect costs are those incurred for common or joint purposes that benefit more than one activity. These costs should be allocated so that the

¹ Generally referred to as federal cognizant agency for indirect costs.

program bears its fair share of total indirect costs. To do this, a recipient must develop an indirect cost rate. This rate, expressed in percentage terms, is applied to direct costs in order to determine the amount of reimbursement a recipient can obtain for indirect costs. When indirect cost rates cannot be readily determined, recipients may negotiate a fixed amount to be used as a substitute. In some cases, indirect costs are limited by legislation. Any excess indirect cost caused by such limitations may not be shifted to other grants.

Cost Allocation Plan

B.7 In order to recover indirect costs, the recipient must have a cost allocation plan² that provides the basis for the indirect cost rate. To be acceptable, the plan must cover all indirect costs of the department administering the grant and other agencies' costs that will be charged against the grant. The plan should (a) describe the services provided and explain their relevance to the grant programs, (b) list the expenses to be charged to the grants, and (c) explain the method used to distribute costs.

B.8 The Department of Health and Human Services, with OMB approval, has issued instructions to state and local governments for the preparation of cost allocation plans. State agencies and departments must have their plans approved before indirect costs can be recovered. Local governments and departments need not submit plans for approval unless requested to by the agency responsible for reviewing their plans. However, they must retain their plans, in case of a subsequent audit.

Cognizant Agency List

B.9 All federal programs incur direct and indirect costs as part of their ongoing operations. In order to spread the administrative load of plan review and approval, the OMB publishes a list of agencies and the organizations whose plans they review.

OMB CIRCULAR A-102 UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS-IN-AID TO STATE AND LOCAL GOVERNMENTS

WHAT IS CIRCULAR A-102?

B.10 Circular A-102 establishes uniform financial and other administrative requirements for grants to state and local governments. It promotes uniformity and consistency among federal agencies in their administration of grants. It establishes uniform requirements in sixteen areas. Only those specific requirements imposed by legislation establishing a grant program can take precedence over A-102.

²For states and larger cities, there are usually two allocation plans, one for centralized services and one at the department or agency level.

The following is a summary of specific attachments of the circular.

Attachment

- A. Cash depositories. State and local governments can use their regular banking procedures, without any requirements for separate bank accounts, or special bank eligibility procedures. Use of minority banks is encouraged.
- B. Bonding and insurance. Except as otherwise required by law, recipients can use normal bonding and insurance procedures for contracts of \$100,000 or less. If the agency is certain that the government's interests are adequately protected, the recipient's procedures may be used for contracts larger than \$100,000. If that is not the case, construction contracts over \$100,000 must have a 5 percent bid guarantee, a 100 percent performance bond, and a 100 percent payment bond. No other federal requirements in this area should be imposed.
- C. Records retention. Recipients may follow their own practices as long as they retain records for three years, in order to allow access for audit and public examination. If audit findings are not resolved, the records shall be retained beyond three years. The retention period starts when the annual or final expenditure report has been submitted or, for nonexpendable property, from the date of final disposition.

Attachment

- D. Waiver of single state agency requirements. When requested by a state, federal agencies should waive or remove single state agency requirements. Such requirements set up impediments to effective administration. Future legislation should avoid single state agency requirements if possible.
- E. Program income. Program income means gross income earned by the recipient entity from grant-supported activities. Interest earned on advances of federal funds shall be remitted to the federal agency except for interest earned on advances to states and instrumentalities of a state. Other income attributable to the grant should be used to increase the scope of the project. Program income must be deducted from the total project cost to determine the amount in which the federal government will share, or it must be applied toward the matching share (with federal agency permission).³
- F. Matching share. Standards are established for determining the matching contribution. It can consist of charges that are project costs, including cash and "in-kind" contributions. In-kind contributions must be necessary and reasonable, identifiable from the grantee's records, properly valued, and not claimed for any other federal program.

³The federal agency making the award determines which method of using grant program income will be followed.

Specific guidelines are set forth calculating the value of in-kind services provided by volunteers and contributions of materials, equipment, buildings, land, and space.

G. Standards for grantees' financial management systems. Standards are prescribed for financial management systems used for grant-supported activities. Federal agencies will not impose requirements other than for current, accurate, and complete disclosure of financial results; adequate identification of source and application of funds; effective control and accountability for funds and property; comparison of actual and budgeted amounts; minimizing time elapsing between receipt and expenditure of funds; a cost allocation plan; and overall organization audits performed at the direction of the grantee. See Attachment P dealing with audits.

H. Financial reporting requirements. Four standard reporting forms are provided to replace the different forms previously required for each grant program.

1. Financial status report. To report status of funds for all nonconstruction programs.
2. Federal cash transactions. To monitor cash balances when funds are advanced to grantees by letter of credit or Treasury checks.

Attachment

3. Request for advance or reimbursement. For all nonconstruction programs when advance letter of credit or predetermined advance payments are not used. May be submitted monthly.
 4. Outlay report and request for reimbursement. For reimbursement on all construction programs. May be submitted monthly.
- I. Monitoring and reporting program performance. Recipients will be held responsible for monitoring programs to assure that time schedules are met and that performance goals are achieved. Periodic reports of progress, documented with quantitative data when possible, will be required.⁴ If goals are not met, or costs are exceeding budget, these conditions must be reported. Between reporting dates, grantees must report any unusual conditions or events that will affect achieving goals within the time period specified.
- J. Grant payment requirement. A letter of credit will be used for all grants, except construction grants, for which it is optional, when there is a continued relationship of at least twelve months, when the payment for a year would exceed \$120,000, and when the recipient's financial management system meets federal standards. Funds will be

⁴These reports are submitted together with the financial status reports.

advanced⁵ when the annual amount is less than \$120,000. Reimbursement will be used when there is not an adequate financial management system.

K. Budget revision procedures. For nonconstruction grants, prior federal approval for budget revision must be obtained for the following reasons:

1. There is a change in the program's scope or objective or a need for additional federal funding.
2. The cumulative amount of transfers among object class categories or among programs, functions, or activities exceeds 5 percent or \$100,000.⁶
3. Indirect cost amounts are to be used for direct costs (if required by the federal agency) or if the budget revision contains items requiring FMC 74-4 approval.
4. Recipients plan to transfer funds allocated for training to other categories of expenses.

Attachment

Construction grants need approval for revisions only in the case of (1). When federal funds are expected to exceed needs by more than 5 percent or \$5,000, the federal agency must be notified.

L. Grant closeout procedures. Federal agencies must establish closeout procedures that provide for prompt payments by the grantor or prompt refunds by the grantee, reports within ninety days of completion, adjustment of the federal share, accounting for government property, and retaining the right of recovery until final audit. Federal agencies must also develop procedures to be followed when the grantee does not comply with the grant agreement and the grant is terminated.

M. Standard forms for applying for federal assistance. With one exception, all state, local, and Indian tribal governments applying for federal grants will use the forms outlined in this attachment. Most formula grants do not require grantees to apply for assistance on a project basis. Hence, these programs are not required to use the forms.

N. Property management system. Standards governing the use and disposition of federally financed property are prescribed. The grantee's property management procedures must provide for accurate records, bi-annual inventories, adequate maintenance and control, and proper sales procedures. Each federal agency must prescribe requirements covering

⁵By Treasury check.

⁶This occurs only when required by the federal grantor agency.

real property for grantees. Such requirements will cover, at a minimum, the following:

1. Vesting title
2. Use of property in other projects
3. Disposition after use

In general, after using the property, the grantee will request disposition instructions from the federal agency. The federal agency shall observe the following rules: The grantee may compensate the government and retain title, sell the property and pay the government, or transfer title for the property back to the government.⁷

O. Procurement standards. The attachment outlines four methods for making procurements under the terms and conditions of grants:

1. Small purchase procedures
2. Competitive sealed bids (formal advertising)

Attachment

3. Competitive negotiation
4. Noncompetitive negotiation

P. Audit Requirements. Studies by the Joint Financial Management Improvement Program, the National Intergovernmental Audit Forum, the General Accounting Office, and others point toward a new audit approach. The studies emphasize the fact that a state or local agency that has a number of individual grants could be subject to an audit of each grant. Such audits are not only uneconomical but fail to provide any overall judgment on the reliability or efficiency of the grantee organization. These studies indicate the need for a total audit; one in which an organization as a whole is audited, not just one individual grant or another. This concept will require a great deal of interagency and intergovernmental cooperation. The audit work will be done using a single audit guide that meets the basic needs of all users.

Recent significant changes--total audit concept. Until recently audits were covered in Attachment G. Now they will be covered in this new attachment. Covering audits in a separate attachment highlights the major importance ascribed to this facet of financial management. To summarize, there are two principal objectives in establishing the new requirements:

1. To reemphasize that grantee audits are to be made on an organizationwide basis, rather than on a grant-by-grant basis.

⁷Similar requirements are provided in detail for personal property.

2. To clarify and improve the rules governing organizationwide audits of federally assisted programs and exclude smaller recipients of federal assistance from these audit requirements. The provisions of the attachment do not limit the authority of federal agencies to make audits of a recipient organization. However, if independent audits arranged for by state and local governments meet the requirements prescribed, all federal agencies shall rely on them, and any additional audit work should build upon the work already done.⁸

⁸See note 4 in chapter 1 of this guide.

APPENDIX C

REPORT REQUIRED BY THE U.S. GENERAL ACCOUNTING OFFICE AN INTERPRETATION OF SAS NO. 30, REPORTING ON INTERNAL ACCOUNTING CONTROL

C.1 Question - SAS No. 30, Reporting on Internal Accounting Control, paragraph 48, states that an auditor may be requested by a specified regulatory agency to report on internal accounting control based solely on a study and evaluation made in an audit of financial statements. The U.S. General Accounting Office's (GAO's) Standards for Audit of Governmental Organizations, Programs, Activities and Functions, 1981 revision (the Yellow Book), requires such a report on the study and evaluation of internal accounting controls made as part of the financial and compliance audit, and it makes reference to the sample report given in SAS No. 30, paragraph 49. The GAO reporting standards, however, go beyond SAS No. 30, and require the auditor to identify in his report the entity's significant accounting controls and those controls identified that were and were not evaluated.¹ How should the auditor identify and classify accounting controls, and how should the sample report given in SAS No. 30 be modified to include those representations?

C.2 Interpretation - The GAO's standards state that they incorporate generally accepted auditing standards, and they make reference to SAS No. 1, section 320, "The Auditor's Study and Evaluation of Internal Control," and to SAS No. 30 as giving applicable guidance. Auditing literature does not give a comprehensive list of internal accounting controls applicable to all entities. Nevertheless, SAS No. 1, section 320.04, recognizes the need to clearly identify the elements of an entity's total management information system, which includes information required for financial and other operating purposes, that are comprehended in internal accounting control. Section 320.20 states that "transactions are the basic components of business operations and, therefore, the primary subject matter of internal control." "Transaction" is defined as the entire cycle of steps necessary to complete the exchange of assets or services with parties outside the entity or the transfer or use of assets or services within it. The definition of accounting control given in section 320.28 is expressed in relation to the functions involved in the authorization, execution, and recording of transactions and maintenance of accountability for assets.

C.3 Thus, SAS No. 30, paragraph 20, states, with respect to a study and evaluation of an internal accounting control system made for the purpose of expressing an opinion on it, that "the accountant should identify the classes of transactions processed and the related assets and, for each significant class, identify the flow of transactions from authorization through execution and recording of transactions and the accountability for the resulting

[Reprinted from the Journal of Accountancy (April 1982): 119-120.]

¹The Yellow Book states on page 29 that the requirement for a report "does not require any additional audit effort other than that required as part of a normal financial and compliance audit. . . ."

assets." The GAO's standards also recognize this approach for the GAO's reporting purposes by stating that the requirement to identify the entity's significant internal accounting controls may be satisfied by identifying significant classes of transactions and related assets. Authoritative and other auditing literature recognizes that transactions may be grouped in a variety of ways and gives examples of some possible ways.

C.4 SAS No. 30, paragraph 20, states that groupings may be made on the basis of cycles of business activity or business functions. Business activity can be categorized by balance sheet accounts, accounting applications or significant transaction cycles. For example, classification by accounting system application could include cash receipts and disbursements, program receipts from the federal government, billings and receivables, purchasing, receiving and accounts payable, property and equipment, payroll, and indirect costs. Classification by transaction cycles could include the financing or treasury cycle, revenue, production, purchasing or disbursement, and external reporting cycles. With respect to controls of federal agencies, departments, and programs, for example, four cycles could be identified—disbursements, receipts, production, and time cycles—the first three of which represent categories of federal government transactions that occur daily and the last representing other federal government events that occur periodically.

C.5 Several variations are possible in the classification. An entity might classify its transactions into fewer or more than the four cycles mentioned in the preceding paragraph. For example, the financing or treasury cycle might be classified as separate investments and debt cycles. For federal agencies, departments, and programs, the disbursements cycle could be subdivided into, among others, grants, loans, entitlements, payroll, purchasing, property, and equipment; the receipts cycle could include taxes, duties, fines, and licenses, sales of goods and services and cash receipts; and the time cycle could include inventories, financial reports, and doubtful accounts receivable. An entity might make its classifications on an entitywide basis or on a departmental basis at the local operating units.

C.6 SAS No. 1, section 320.67, notes that classification generally should be broad (for example, cash disbursements rather than specific types of disbursements), although the section points out that there may be circumstances when a more narrow distinction may be appropriate because controls differ for certain transactions within a class.

C.7 For reporting purposes, the sample auditor's report, given in paragraph 49 of SAS No. 30, on a study and evaluation made as part of the audit that is not sufficient for expressing an opinion on the system taken as a whole should be modified to include the identification of the entity's significant accounting controls and those controls identified that were and were not evaluated. An example of such a report follows:

We have examined the financial statements of [name of entity] for the year ended June 30, 19X1, and have issued our report thereon dated August 23, 19X1. As part of our examination, we made a study and evaluation of the system of internal accounting control of [name of entity] to the extent we considered necessary to evaluate

the system as required by generally accepted auditing standards and the standards for financial and compliance audits contained in the U.S. General Accounting Office Standards for Audit of Governmental Organizations, Programs, Activities and Functions. For the purpose of this report, we have classified the significant internal accounting controls in the following categories [identify control categories].² Our study included all of the control categories listed above except that we did not evaluate the accounting controls over [identify any categories not evaluated] because [state reasons for excluding any category from the evaluation]. The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the entity's financial statements. Our study evaluation was more limited than would be necessary to express an opinion on the system of internal accounting control taken as a whole or on any of the categories of controls identified above.

The management of [name of entity] is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation

²Given below are examples of three different ways in which controls might be classified. The auditor should modify these examples or use other classifications as appropriate for the particular circumstances on which he is reporting.

1. Cycles of the Entity's Activity

- o Treasury or financing
- o Revenue/receipts
- o Purchases/disbursements
- o External financial reporting

2. Financial Statement Captions

- o Cash and cash equivalents
- o Receivables
- o Inventory
- o Property and equipment
- o Payables and accrued liabilities
- o Debt
- o Fund balance

3. Accounting Applications

- o Billings
- o Receivables
- o Cash receipts
- o Purchasing and receiving
- o Accounts payable
- o Cash disbursements
- o Payroll
- o Inventory control
- o Property and equipment
- o General ledger

of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate. Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of [name of entity] taken as whole or on any of the categories of controls identified in the first paragraph. However, our study and evaluation disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements of [name of entity] may occur and not be detected within a timely period.³ [A description of the material weaknesses that have come to the auditor's attention would follow.]⁴

These conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in our examination of the 19X1 financial statements, and this report does not affect our report on the financial statements dated August 23, 19X1.

This report is intended solely for the use of management and [name of regulatory agency or other third party] and should not be used for any other purpose.⁵

C.8 The Yellow Book, page 30, states the following: "There are a number of reasons why a study and evaluation of internal accounting control may not be made. They include:

1. The entity is so small that it is not feasible to have an adequate internal control system.

³If the study and evaluation discloses no material weaknesses, this sentence would state, "However, our study and evaluation disclosed no condition that we believed to be a material weakness," and the following paragraph of this report, which begins, "These conditions. . . ," would be omitted.

⁴All material weaknesses that have come to the auditor's attention during the audit would be described, whether or not they relate to a category of controls that was excluded from the study and evaluation. SAS No. 20, Required Communication of Material Weaknesses in Internal Accounting Control, paragraph 3, notes that the auditor may become aware of material weaknesses through the preliminary review of the system or by performing substantive tests of account balances.

⁵SAS No. 30, footnote 7, states that this form of reporting is appropriate even though by law or regulation the accountant's report may be made a matter of public record.

2. The auditor may conclude that the audit can be performed more efficiently by expanding substantive audit tests, thus placing very little reliance on the internal control system.⁶
3. The existing internal control system may contain so many weaknesses that the auditor has no choice but to rely on substantive testing, thus virtually ignoring the internal control system."

C.9 The Yellow Book, page 30, also states that if a study and evaluation is not made, "the auditors must state in their report why a study was not made."⁷

⁶SAS No. 1, section 320.55, states that the auditor's conclusion that it is more efficient not to test compliance with controls to justify reliance on them in making substantive tests may result from consideration of the nature and amount of the transactions or balances involved, the data processing methods being used, and the auditing procedures that can be applied in making substantive tests.

⁷For reporting guidance when no significant categories are studied and evaluated beyond the preliminary review phase, see the auditing interpretation entitled "Report Required by U.S. General Accounting Office Based on a Financial and Compliance Audit When a Study and Evaluation Does Not Extend Beyond the Preliminary Review Phase," dated December 1983.

APPENDIX D

AN INTERPRETATION OF SAS NO. 22, PLANNING AND SUPERVISION

Planning Considerations for an Audit of a Federally Assisted Program

Question

1. The first standard of field work states that "the work is to be adequately planned," and SAS No. 22, *Planning and Supervision*, gives guidance on planning considerations. SAS No. 22, paragraph 3, states that, "In planning the examination, the auditor should consider matters relating to the entity's business and the industry in which it operates . . . and the nature of reports expected to be rendered." Paragraph 7 states that the auditor should obtain knowledge of matters that relate to the entity's business and its organization, as well as matters that affect the industry in which it operates, such as government regulations, as they relate to his examination.
2. What particular matters should the auditor consider in planning the audit of a federally assisted program?

Interpretation

3. The auditor should be aware of governmental standards for audits of federally assisted programs. These standards may be found in the publication of the U.S. General Accounting Office (GAO) entitled *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*.¹ In planning the audit, the auditor should be aware that GAO standards frequently extend beyond the AICPA's generally accepted auditing standards, particularly in the following areas:

- Working papers.
 - Notification of parties other than the entity's management about irregularities and illegal acts.
4. Other matters of particular concern in planning an audit of a federally assisted program include:
- Determination of the type of engagement to be performed.
 - Identification of the entity.

1. The GAO has proposed revisions to the current edition of its standards.

- Determination of the nature of the financial information to be audited and the appropriate form of reporting.
- Identification of the parties to whom the auditor has reporting obligations.
- Consideration of participant eligibility requirements.

5. *Working Papers.* According to SAS No. 1, section 338, *Working Papers*, the quantity, type, and content of working papers should fit the “circumstances of the engagement.” In the audit of a federally assisted program, these circumstances include access by governmental audit staffs to the working papers and the GAO’s requirement to document the supervisory review. The GAO’s standards require working papers that are clear and understandable without supplementary oral explanations.² Thus, the working papers should not consist solely of work programs or checklists on which the auditor has indicated the steps that have been performed. In accordance with section 338.05, the auditor’s working papers should be in sufficient detail to permit reasonable identification of the work he has done and the conclusions he has reached. Section 338.03 lists appropriate forms of documentation in addition to work programs and checklists, such as analyses, memoranda, and commentaries and schedules.

6. The working papers should document significant aspects of the examination. For example, they should document the auditor’s study and evaluation of the system of internal accounting control as a basis for reliance thereon in determining the nature, timing, and extent of substantive audit tests. They should identify the nature, source, and amounts of the accounting entries or financial items tested and any related evidential matter examined. In addition, working papers should describe the nature of testing procedures performed and provide detailed information about exceptions found and their disposition. Also, the working papers should show that the work of any assistants has been reviewed.

7. *Notification of Parties Other Than the Entity’s Management About Irregularities and Illegal Acts.* The auditor should be aware that governmental standards go beyond AICPA auditing standards

2. The General Accounting Office publication entitled *Guidelines for Financial and Compliance Audits of Federally Assisted Programs* (Washington, D.C.: Government Printing Office, 1980), pp. 12–16, 36–50, gives recommendations on documentation of the review of internal accounting control and tests of account balances and transactions.

as they relate to notification when the examination indicates that irregularities or illegal acts may exist.

8. SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*, paragraph 14, states that the auditor should discuss such matters with an appropriate level of management that is at least one level above the level of those involved. Neither SAS No. 16 nor SAS No. 17, *Illegal Acts by Clients*, requires the auditor to notify parties other than personnel within the client's organization. For example, SAS No. 17, paragraph 19, states that, "Generally, the auditor is under no obligation to notify those parties," and that the decision to notify other parties is the responsibility of management.

9. Governmental requirements, however, call for the auditor not only to promptly report instances of irregularities to the audited entity's management officials above the level of involvement, but also to report the matter to the funding agency or other specified agency.³ The management of the entity being audited typically is aware of this reporting requirement.

10. SAS No. 16, paragraph 14, and SAS No. 17, paragraphs 18 and 19, discuss situations in which the auditor may wish to consult with his legal counsel about withdrawing from the engagement. This guidance would also be appropriate in the audit of a federally assisted program. However, it would not be appropriate for the auditor to withdraw from the engagement without first reporting the irregularity or illegal act to management and appropriate federal agencies.

11. In an audit of a federally assisted program, the auditor may find instances of noncompliance with the terms of a grant award which by their nature are not irregularities or illegal acts. In those situations the auditor should disclose significant instances of non-

3. In October 1979, the Office of Management and Budget (OMB) issued *Attachment P-Audit Requirements* to its Circular A-102, *Uniform Administrative Requirements for Grants-in-Aid to State and Local Governments* (supplemented and revised in August and September, 1980). *Attachment P* gives the OMB the authority to designate a "cognizant agency" to be assigned the audit responsibility for major recipient organizations. *Attachment P* states that the responsibilities of the cognizant agency include acting as a liaison among federal agencies, independent auditors, and recipient organizations, receiving audit reports of the recipient organization and reviewing and distributing them to appropriate federal audit officials, and reviewing notification of irregularities from auditors and informing other affected audit agencies.

compliance in his report, but ordinarily he would not have to otherwise notify the federal agency.

12. *Determination of the Type of Engagement to Be Performed.* SAS No. 22, paragraphs 3 and 4, states that, "audit planning involves developing an overall strategy for the expected conduct and scope of the examination," and that the auditor "may consider discussing the type, scope, and timing of the examination with management of the entity. . . ." The discussion with management should include an agreement about which of the various types of engagement will be performed, since the GAO's standards address three types of engagement, any combination of which a federal agency may request the auditor to perform. The first type of engagement is an examination of financial statements and an evaluation of compliance with laws and regulations; the second type concerns efficiency and economy in the use of resources; and the third type considers whether desired program results are effectively achieved. If the auditor is requested to examine financial statements and issue a report on them without also reporting on the evaluation of compliance, he should see if management is aware that such a report might not be acceptable to the GAO, the funding agency, or the agency requiring the audit. If a contract, proposal, or engagement letter is used, the auditor may want to consider including in it a clear statement as to the type of engagement and whether that engagement is intended to meet a federal agency's requirements or has been approved by the appropriate federal agency.

13. *Identification of the Entity.* Obtaining knowledge of the entity's organization, as required by SAS No. 22, paragraph 7, is particularly important when the entity receives funds under several governmental assistance programs. The auditor should discuss and reach agreement with management and, if he considers it necessary, with the appropriate federal agency, as to the grants or programs to be audited. If a contract, proposal, or engagement letter is issued, it should set forth the understanding as to the grants or programs to be audited.⁴

14. *Determination of the Nature of Financial Information to Be Audited and the Appropriate Form of Reporting.* In considering the nature of reports expected to be rendered, as required by SAS No.

4. *Attachment P* requires that audits of financial operations of state and local government entities that receive federal aid are to be made on an organization-wide basis rather than on a grant-by-grant basis.

22, paragraph 3(g), the auditor should be aware that in a financial and compliance audit of a federally assisted program his reporting responsibilities may encompass a) financial statements of one or more programs, b) financial statements of an organization having one or more federally assisted programs (an "organization-wide" audit),⁵ or c) selected financial information such as specified elements, accounts, or items of a financial statement of a federally assisted program.

15. The financial statements or information may be presented in accordance with generally accepted accounting principles or on a comprehensive basis of accounting other than generally accepted accounting principles, such as the cash basis or a basis of accounting prescribed by a regulatory agency.

16. In deciding between the standard form of auditor's report given in SAS No. 2 or some other form of report, the auditor should consider whether the statements constitute complete financial statements and whether they have been prepared in accordance with generally accepted accounting principles.

17. The auditor should follow the guidance in SAS No. 14, *Special Reports*, paragraphs 2-8, when the financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles. He should look to paragraphs 9-14, "Reports on Specified Elements, Accounts or Items of a Financial Statement," and the related auditing interpretations when he concludes that the statements or information do not constitute complete financial statements.

18. If the auditor concludes that financial statements that a federal agency requires to be presented on a prescribed form are in fact presented on a comprehensive basis of accounting other than generally accepted accounting principles, he should follow the guidance in SAS No. 14, paragraphs 2-8, and the related auditing interpretations.

19. If the auditor is required to report on other financial information in addition to the basic financial statements, he should follow the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor—Submitted Documents*.

5. See footnote 4.

20. An entity may have several grants or programs, each with separate reporting requirements that may not be met by a report on the entity's basic financial statements. In such circumstances the auditor should consider rendering reports on the individual grants or programs, assuming that the scope of his audit is sufficient for him to do so.

21. When a federal agency audit guide specifies the wording of the auditor's report (for example, on a preprinted form or schedule), the auditor should consider whether that wording calls for assertions that are not consistent with his function or responsibility as described in the contract, proposal, or engagement letter. If there is an inconsistency, the auditor should consider revising the planned work or the wording of the audit report as called for in SAS No. 14, paragraphs 20-21.

22. In all of the situations discussed above, the auditor should be familiar with the GAO's reporting standards as well as the requirements of the applicable federal agency. The GAO's standards call for a report that contains an opinion on the financial statements and explanations of violations of legal or regulatory requirements.

23. *Identification of the Parties to Whom the Auditor Has Reporting Obligations.* To fulfill the requirements of SAS No. 22 (regarding the knowledge of the industry and government regulations) when auditing federally assisted programs, the auditor should obtain an understanding of his reporting obligations to parties other than management of the audited entity. A governmental agency may allow, or even require, the entity being audited to make the audit arrangements with the auditor; however, the agency may still expect the auditor to fulfill its requirements, such as submitting the audit report and reporting irregularities to the agency.⁶ Also, the auditor may have a reporting obligation to more than one agency. For example, a local housing authority may be the contracting agency for an audit of a housing grant, the Department of Housing and Urban Development may be the funding agency, and both may have reporting requirements.

24. *Consideration of Participant Eligibility Requirements.* In planning the scope of the examination, the auditor should obtain knowledge of the nature of the entity's business and consider mat-

6. See the section of this auditing interpretation entitled "Notification of Parties Other than the Entity's Management About Irregularities and Illegal Acts."

ters affecting the industry in which it operates, including government regulations, as they relate to the examination.

25. The nature of some federally financed or sponsored programs is to provide financial assistance to eligible individuals. The eligibility requirements for participation in the program usually are specified in laws, regulations, or contracts applicable to the program.

26. SAS No. 17, *Illegal Acts by Clients*, paragraph 7, discusses the need to consider compliance with laws and regulations. It states that "as part of his examination, the auditor considers laws and regulations that have a direct effect on amounts presented in the financial statements," and states as an example that "applicable laws or regulations may affect the amount of revenue accrued under government contracts."

27. Thus, the auditor should plan his audit to test compliance with those laws, regulations, or contractual terms that set forth the requirements for individuals who receive payments under the program. The specific audit objective is to determine that amounts classified in the financial statements as "public assistance expenditures" (or a similar description) should include only expenditures to persons entitled to receive public assistance.

28. In the audit of a student loan program, for example, the auditor should test not only whether payments were made to students but also whether the students met the funding agency's eligibility requirements on matters such as financial need.

29. If the auditor concludes, on the basis of the evidential matter obtained, that the financial statements should, but do not properly include and classify a liability for payments made to ineligible persons, he should consider the need to qualify his opinion for a departure from generally accepted accounting principles. If he is unable to obtain sufficient evidential matter to form a conclusion concerning the eligibility of persons receiving payments, he should consider whether to express a qualified opinion or disclaim an opinion because of a limitation on the scope of his examination.

30. The auditor should also consider the need to explain in his report violations of regulatory requirements, including instances of noncompliance with eligibility requirements, as required by the GAO's auditing standards.

APPENDIX E

THE SINGLE AUDIT ACT OF 1984
PUBLIC LAW 98-502

Ninety-eighth Congress of the United States of America

AT THE SECOND SESSION

*Begun and held at the City of Washington on Monday, the twenty-third day of January,
one thousand nine hundred and eighty-four*

An Act

To establish uniform audit requirements for State and local governments receiving
Federal financial assistance.

*Be it enacted by the Senate and House of Representatives of the
United States of America in Congress assembled,*

SHORT TITLE; PURPOSE

SECTION 1. (a) This Act may be cited as the "Single Audit Act of 1984".

(b) It is the purpose of this Act—

(1) to improve the financial management of State and local governments with respect to Federal financial assistance programs;

(2) to establish uniform requirements for audits of Federal financial assistance provided to State and local governments;

(3) to promote the efficient and effective use of audit resources; and

(4) to ensure that Federal departments and agencies, to the maximum extent practicable, rely upon and use audit work done pursuant to chapter 75 of title 31, United States Code (as added by this Act).

AMENDMENT TO TITLE 31, UNITED STATES CODE

SEC. 2. (a) Subtitle V of title 31, United States Code, is amended by adding at the end thereof the following new chapter:

**"CHAPTER 75—REQUIREMENTS FOR SINGLE
AUDITS**

"Sec.

"7501. Definitions.

"7502. Audit requirements; exemptions.

"7503. Relation to other audit requirements.

"7504. Cognizant agency responsibilities.

"7505. Regulations.

"7506. Monitoring responsibilities of the Comptroller General.

"7507. Effective date; report.

"§ 7501. Definitions

"As used in this chapter, the term—

"(1) 'cognizant agency' means a Federal agency which is assigned by the Director with the responsibility for implementing the requirements of this chapter with respect to a particular State or local government.

"(2) 'Comptroller General' means the Comptroller General of the United States.

"(3) 'Director' means the Director of the Office of Management and Budget.

"(4) 'Federal financial assistance' means assistance provided by a Federal agency in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations, but does not include direct Federal cash assistance to individuals.

"(5) 'Federal agency' has the same meaning as the term 'agency' in section 551(1) of title 5, United States Code.

"(6) 'generally accepted accounting principles' has the meaning specified in the generally accepted government auditing standards.

"(7) 'generally accepted government auditing standards' means the standards for audit of governmental organizations, programs, activities, and functions, issued by the Comptroller General.

"(8) 'independent auditor' means—

"(A) an external State or local government auditor who meets the independence standards included in generally accepted government auditing standards, or

"(B) a public accountant who meets such independence standards.

"(9) 'internal controls' means the plan of organization and methods and procedures adopted by management to ensure that—

"(A) resource use is consistent with laws, regulations, and policies;

"(B) resources are safeguarded against waste, loss, and misuse; and

"(C) reliable data are obtained, maintained, and fairly disclosed in reports.

"(10) 'Indian tribe' means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

"(11) 'local government' means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

"(12) 'major Federal assistance program' means any program for which total expenditures of Federal financial assistance by the State or local government during the applicable year exceed—

"(A) \$20,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$7,000,000,000;

"(B) \$19,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$6,000,000,000 but are less than or equal to \$7,000,000,000;

"(C) \$16,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$5,000,000,000 but are less than or equal to \$6,000,000,000;

"(D) \$13,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$4,000,000,000 but are less than or equal to \$5,000,000,000;

“(E) \$10,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$3,000,000,000 but are less than or equal to \$4,000,000,000;

“(F) \$7,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$2,000,000,000 but are less than or equal to \$3,000,000,000;

“(G) \$4,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$1,000,000,000 but are less than or equal to \$2,000,000,000;

“(H) \$3,000,000 in the case of a State or local government for which such total expenditures for all programs exceed \$100,000,000 but are less than or equal to \$1,000,000,000; and

“(I) the larger of (i) \$300,000, or (ii) 3 percent of such total expenditures for all programs, in the case of a State or local government for which such total expenditures for all programs exceed \$100,000 but are less than or equal to \$100,000,000.

“(13) ‘public accountants’ means those individuals who meet the qualification standards included in generally accepted government auditing standards for personnel performing government audits.

“(14) ‘State’ means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe.

“(15) ‘subrecipient’ means any person or government department, agency, or establishment that receives Federal financial assistance through a State or local government, but does not include an individual that receives such assistance.

“8 7502. Audit requirements; exemptions

“(a)(1)(A) Each State and local government which receives a total amount of Federal financial assistance equal to or in excess of \$100,000 in any fiscal year of such government shall have an audit made for such fiscal year in accordance with the requirements of this chapter and the requirements of the regulations prescribed pursuant to section 7505 of this title.

“(B) Each State and local government that receives a total amount of Federal financial assistance which is equal to or in excess of \$25,000 but less than \$100,000 in any fiscal year of such government shall—

“(i) have an audit made for such fiscal year in accordance with the requirements of this chapter and the requirements of the regulations prescribed pursuant to section 7505 of this title; or

“(ii) comply with any applicable requirements concerning financial or financial and compliance audits contained in Federal statutes and regulations governing programs under which such Federal financial assistance is provided to that government.

“(C) Each State and local government that receives a total amount of Federal financial assistance which is less than \$25,000 in any

fiscal year of such government shall be exempt for such fiscal year from compliance with—

“(i) the audit requirements of this chapter; and

“(ii) any applicable requirements concerning financial or financial and compliance audits contained in Federal statutes and regulations governing programs under which such Federal financial assistance is provided to that government.

The provisions of clause (ii) of this subparagraph do not exempt a State or local government from compliance with any provision of a Federal statute or regulation that requires such government to maintain records concerning Federal financial assistance provided to such government or that permits a Federal agency or the Comptroller General access to such records.

“(2) For purposes of this section, a State or local government shall be considered to receive Federal financial assistance whether such assistance is received directly from a Federal agency or indirectly through another State or local government.

“(b)(1) Except as provided in paragraphs (2) and (3), audits conducted pursuant to this chapter shall be conducted annually.

“(2) If a State or local government is required—

“(A) by constitution or statute, as in effect on the date of enactment of this chapter, or

“(B) by administrative rules, regulations, guidelines, standards, or policies, as in effect on such date,

to conduct its audits less frequently than annually, the cognizant agency for such government shall, upon request of such government, permit the government to conduct its audits pursuant to this chapter biennially, except as provided in paragraph (3). Such audits shall cover both years within the biennial period.

“(3) Any State or local government that is permitted, under clause (B) of paragraph (2), to conduct its audits pursuant to this chapter biennially by reason of the requirements of a rule, regulation, guideline, standard, or policy, shall, for any of its fiscal years beginning after December 31, 1986, conduct such audits annually unless such State or local government codifies a requirement for biennial audits in its constitution or statutes by January 1, 1987. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

“(c) Each audit conducted pursuant to subsection (a) shall be conducted by an independent auditor in accordance with generally accepted government auditing standards, except that, for the purposes of this chapter, such standards shall not be construed to require economy and efficiency audits, program results audits, or program evaluations.

“(d)(1) Each audit conducted pursuant to subsection (a) for any fiscal year shall cover the entire State or local government's operations except that, at the option of such government—

“(A) such audit may, except as provided in paragraph (5), cover only each department, agency, or establishment which received, expended, or otherwise administered Federal financial assistance during such fiscal year; and

“(B) such audit may exclude public hospitals and public colleges and universities.

“(2) Each such audit shall encompass the entirety of the financial operations of such government or of such department, agency, or establishment, whichever is applicable, and shall determine and report whether—

"(A)(i) the financial statements of the government, department, agency, or establishment present fairly its financial position and the results of its financial operations in accordance with generally accepted accounting principles; and

"(ii) the government, department, agency, or establishment has complied with laws and regulations that may have a material effect upon the financial statements;

"(B) the government, department, agency, or establishment has internal control systems to provide reasonable assurance that it is managing Federal financial assistance programs in compliance with applicable laws and regulations; and

"(C) the government, department, agency, or establishment has complied with laws and regulations that may have a material effect upon each major Federal assistance program.

In complying with the requirements of subparagraph (C), the independent auditor shall select and test a representative number of transactions from each major Federal assistance program.

"(3) Transactions selected from Federal assistance programs, other than major Federal assistance programs, pursuant to the requirements of paragraphs (2)(A) and (2)(B) shall be tested for compliance with Federal laws and regulations that apply to such transactions. Any noncompliance found in such transactions by the independent auditor in making determinations required by this paragraph shall be reported.

"(4) The number of transactions selected and tested under paragraphs (2) and (3), the selection and testing of such transactions, and the determinations required by such paragraphs shall be based on the professional judgment of the independent auditor.

"(5) Each State or local government which, in any fiscal year of such government, receives directly from the Department of the Treasury a total of \$25,000 or more under chapter 67 of this title (relating to general revenue sharing) and which is required to conduct an audit pursuant to this chapter for such fiscal year shall not have the option provided by paragraph (1)(A) for such fiscal year.

"(6) A series of audits of individual departments, agencies, and establishments for the same fiscal year may be considered to be an audit for the purpose of this chapter.

"(e)(1) Each State and local government subject to the audit requirements of this chapter, which receives Federal financial assistance and provides \$25,000 or more of such assistance in any fiscal year to a subrecipient, shall—

"(A) if the subrecipient conducts an audit in accordance with the requirements of this chapter, review such audit and ensure that prompt and appropriate corrective action is taken on instances of material noncompliance with applicable laws and regulations with respect to Federal financial assistance provided to the subrecipient by the State or local government; or

"(B) if the subrecipient does not conduct an audit in accordance with the requirements of this chapter—

"(i) determine whether the expenditures of Federal financial assistance provided to the subrecipient by the State or local government are in accordance with applicable laws and regulations; and

"(ii) ensure that prompt and appropriate corrective action is taken on instances of material noncompliance with applicable laws and regulations with respect to Federal financial

assistance provided to the subrecipient by the State or local government.

"(2) Each such State and local government shall require each subrecipient of Federal assistance through such government to permit, as a condition of receiving funds from such assistance, the independent auditor of the State or local government to have such access to the subrecipient's records and financial statements as may be necessary for the State or local government to comply with this chapter.

"(f) The report made on any audit conducted pursuant to this section shall, within thirty days after completion of such report, be transmitted to the appropriate Federal officials and made available by the State or local government for public inspection.

(g) If an audit conducted pursuant to this section finds any material noncompliance with applicable laws and regulations by, or material weakness in the internal controls of, the State or local government with respect to the matters described in subsection (d)(2), the State or local government shall submit to appropriate Federal officials a plan for corrective action to eliminate such material noncompliance or weakness or a statement describing the reasons that corrective action is not necessary. Such plan shall be consistent with the audit resolution standard promulgated by the Comptroller General (as part of the standards for internal controls in the Federal Government) pursuant to section 3512(b) of this title.

"§ 7503. Relation to other audit requirements

"(a) An audit conducted in accordance with this chapter shall be in lieu of any financial or financial and compliance audit of an individual Federal assistance program which a State or local government is required to conduct under any other Federal law or regulation. To the extent that such audit provides a Federal agency with the information it requires to carry out its responsibilities under Federal law or regulation, a Federal agency shall rely upon and use that information and plan and conduct its own audits accordingly in order to avoid a duplication of effort.

"(b) Notwithstanding subsection (a), a Federal agency shall conduct any additional audits which are necessary to carry out its responsibilities under Federal law or regulation. The provisions of this chapter do not authorize any State or local government (or subrecipient thereof) to constrain, in any manner, such agency from carrying out such additional audits.

"(c) The provisions of this chapter do not limit the authority of Federal agencies to conduct, or enter into contracts for the conduct of, audits and evaluations of Federal financial assistance programs, nor limit the authority of any Federal agency Inspector General or other Federal audit official.

"(d) Subsection (a) shall apply to a State or local government which conducts an audit in accordance with this chapter even though it is not required by section 7502(a) to conduct such audit.

"(e) A Federal agency that performs or contracts for audits in addition to the audits conducted by recipients pursuant to this chapter shall, consistent with other applicable law, arrange for funding the cost of such additional audits. Such additional audits include economy and efficiency audits, program results audits, and program evaluations.

"§ 7504. Cognizant agency responsibilities

"(a) The Director shall designate cognizant agencies for audits conducted pursuant to this chapter.

"(b) A cognizant agency shall—

"(1) ensure that audits are made in a timely manner and in accordance with the requirements of this chapter;

"(2) ensure that the audit reports and corrective action plans made pursuant to section 7502 of this title are transmitted to the appropriate Federal officials; and

"(3)(A) coordinate, to the extent practicable, audits done by or under contract with Federal agencies that are in addition to the audits conducted pursuant to this chapter; and (B) ensure that such additional audits build upon the audits conducted pursuant to this chapter.

"§ 7505. Regulations

"(a) The Director, after consultation with the Comptroller General and appropriate Federal, State, and local government officials, shall prescribe policies, procedures, and guidelines to implement this chapter. Each Federal agency shall promulgate such amendments to its regulations as may be necessary to conform such regulations to the requirements of this chapter and of such policies, procedures, and guidelines.

"(b)(1) The policies, procedures, and guidelines prescribed pursuant to subsection (a) shall include criteria for determining the appropriate charges to programs of Federal financial assistance for the cost of audits. Such criteria shall prohibit a State or local government which is required to conduct an audit pursuant to this chapter from charging to any such program (A) the cost of any financial or financial and compliance audit which is not conducted in accordance with this chapter, and (B) more than a reasonably proportionate share of the cost of any such audit that is conducted in accordance with this chapter.

"(2) The criteria prescribed pursuant to paragraph (1) shall not, in the absence of documentation demonstrating a higher actual cost, permit (A) the ratio of (i) the total charges by a government to Federal financial assistance programs for the cost of audits performed pursuant to this chapter, to (ii) the total cost of such audits, to exceed (B) the ratio of (i) total Federal financial assistance expended by such government during the applicable fiscal year or years, to (ii) such government's total expenditures during such fiscal year or years.

"(c) Such policies, procedures, and guidelines shall include such provisions as may be necessary to ensure that small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the audit requirements of this chapter.

"§ 7506. Monitoring responsibilities of the Comptroller General

"The Comptroller General shall review provisions requiring financial or financial and compliance audits of recipients of Federal assistance that are contained in bills and resolutions reported by the committees of the Senate and the House of Representatives. If the Comptroller General determines that a bill or resolution contains provisions that are inconsistent with the requirements of this chap-

ter, the Comptroller General shall, at the earliest practicable date, notify in writing—

“(1) the committee that reported such bill or resolution; and

“(2)(A) the Committee on Governmental Affairs of the Senate (in the case of a bill or resolution reported by a committee of the Senate); or

“(B) the Committee on Government Operations of the House of Representatives (in the case of a bill or resolution reported by a committee of the House of Representatives).

“§ 7507. Effective date; report

“(a) This chapter shall apply to any State or local government with respect to any of its fiscal years which begin after December 31, 1984.

“(b) The Director, on or before May 1, 1987, and annually thereafter, shall submit to each House of Congress a report on operations under this chapter. Each such report shall specifically identify each Federal agency or State or local government which is failing to comply with this chapter.”.

(b) The provisions of this Act shall not diminish or otherwise affect the authority of the Tennessee Valley Authority to conduct its own audits of any matter involving funds disbursed by the Tennessee Valley Authority.

(c) The table of chapters for subtitle V of title 31, United States Code, is amended by inserting after the item relating to chapter 73 the following new item:

“75. Requirements for Single Audits 7501”.

Speaker of the House of Representatives.

*Vice President of the United States and
President of the Senate.*